INTERNAL REVENUE
BULLETIN

IRS

HIGHLIGHTS OF THIS ISSUE

Bulletin No. 2019–31
July 29, 2019

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

EMPLOYEE PLANS

NOT 2019-44, page 489.

This notice sets forth updates on the corporate bond monthly yield curve, the corresponding spot segment rates for July 2019 used under § 417(e)(3)(D), the 24-month average segment rates applicable for July 2019, and the 30-year Treasury rates, as reflected by the application of § 430(h)(2)(C)(iv).

INCOME TAX

T.D. 9862, page 477.

The final regulations adopt proposed regulations providing that if a corporation makes a tax-free distribution of the stock of another corporation and the property of one of the corporations becomes the property of a real estate investment trust, gain must be recognized, and taxed at the corporate level, in an amount approximating the amount that would have been recognized if the corporation had disposed of the property in a taxable sale, exchange, or distribution. The final regulations also adopt a proposed limitation providing that the gain immediately recognized by a corporation engaging in certain tax-free distributions and a later conversion transaction will be limited to gain on property traceable to the distribution.

NOT 2019-27, page 484.

This Notice provides methods for calculating W-2 wages for purposes of section 199A(g)(1)(B)(i), which, for certain specified agricultural or horticultural cooperatives provides a limitation based on W-2 wages to the amount of a deduction under section 199A(g)(1)(A) of 9 percent of the lesser of qualified production activities income or taxable income of a Specified Cooperative.

NOT 2019-43, page 487.

Beginning of Construction for Sections 45 and 48; Tolling and Extension of Continuity Safe Harbor to Mitigate Significant National Security Concerns. This notice updates and clarifies the guidance provided in prior IRS notices regarding the beginning of construction for sections 45 and 48. Specifically, the notice provides that the Continuity Safe Harbor may be tolled and extended in certain limited circumstances involving significant national security concerns.

REG-105474-18, page 493.

These proposed regulations provide rules regarding the determination of ownership in a passive foreign investment company ("PFIC") and the treatment of certain income received or accrued by a foreign corporation and assets held by a foreign corporation for purposes of determining whether it is a PFIC, including guidance concerning the qualifying insurance corporation rules. The regulations affect United States persons with direct or indirect ownership interests in certain foreign corporations.

REG-118425-18, page 539.

The proposed regulations provide guidance: (1) to a patron of a cooperative to which subchapter T applies on the income from that cooperative the patron can use to calculate the patron's qualified business income deduction under § 199A(a), (2) on a patron's reduction under § 199A(b)(7) of the patron's § 199A(a) deduction in a taxable year in which the patron receives a specific type of payment from a specified agricultural or horticultural cooperative, and (3) on the deduction for domestic production activities under § 199A(g) available to specified agricultural or horticultural cooperatives and their patrons. The proposed regulations also define patronage and nonpatronage under § 1388.

Finding Lists begin on page ii.

The IRS Mission

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

Introduction

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

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

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

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

The Bulletin is divided into four parts as follows:

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

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

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

Part IV.—Items of General Interest.
This part includes notices of proposed rulemakings, disbarment and suspension lists, and announcements.

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

Part I.

26 CFR 1.337(d)-7

T.D. 9862

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

Certain Transfers of Property to Regulated Investment Companies [RICs] and Real Estate Investment Trusts [REITs]

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations and removal of temporary regulations.

SUMMARY: This document contains final regulations effecting the repeal of the *General Utilities* doctrine by the Tax Reform Act of 1986 and preventing abuse of the Protecting Americans from Tax Hikes Act of 2015 (PATH Act). The final regulations impose corporate-level tax on certain transactions in which property of a C corporation becomes the property of a REIT. The final regulations affect RICs, REITs, C corporations the property of which becomes the property of a RIC or a REIT, and their shareholders.

DATES: *Effective Date*: These regulations are effective on June 7, 2019.

Applicability Dates: For dates of applicability, see §1.337(d)-7(g)(2)(ii).

FOR FURTHER INFORMATION CONTACT: Austin Diamond-Jones, (202) 317-5363 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

This document contains amendments to 26 CFR part 1 under section 337(d) of the Internal Revenue Code (Code).

In *General Utilities & Operating Co. v. Helvering*, 296 U.S. 200 (1935), the Supreme Court held that corporations generally could distribute appreciated property to their shareholders without the recognition of any corporate-level gain (*General Utilities* doctrine). Beginning with legislation in 1969 and culminating in the Tax Reform Act of 1986, Public Law 99-514 (100 Stat. 2085), Congress repealed the *General Utilities* doctrine by enacting section 336(a) to apply gain and loss recognition to liquidating distributions. Section 337(d) directs the Secretary of the Treasury (Secretary) to prescribe regulations that are necessary or appropriate to carry out the purposes of *General Utilities* repeal, including "regulations to ensure that such purposes may not be circumvented through the use of any provision of law or regulations (including . . . part III of this subchapter) or through the use of a regulated investment company, real estate investment trust, or tax exempt entity. . . ."

On June 8, 2016, the Department of the Treasury (Treasury Department) and the IRS published temporary regulations (TD 9770) under section 337(d) (Temporary Regulations) in the **Federal Register** (81 FR 36793) effecting the repeal of the *General Utilities* doctrine as applied to certain transfers of property to RICs and REITs. A notice of proposed rulemaking (REG-126452-15) was published in the **Federal Register** (81 FR 36816) on the same day (2016 Proposed Regulations). The text of the Temporary Regulations served as the text for part of the 2016 Proposed Regulations, which also included an amendment not included in the Temporary Regulations. A correction to the Temporary Regulations was published in the **Federal Register** (81 FR 41800) on June 28, 2016.

In response to the 2016 Proposed Regulations, the Treasury Department and the IRS received one written comment and a letter addressed to the Secretary by the Chairmen and Ranking Members of the Ways and Means Committee of the U.S. House of Representatives and the Finance Committee of the U.S. Senate (Letter). The comment requested a public hearing, which was held on November 9, 2016.

After consideration of the written comment, the Letter, and comments made at the public hearing, the Treasury Department and the IRS adopted the 2016 Proposed Regulations, in part, in final regulations (TD 9810) published in the **Federal Register** (82 FR 5387) on January 18, 2017 (2017 Final Regulations). The 2017 Final Regulations adopted a definition of the term "recognition period" consistent with the definition used in section 1374(d), regarding S corporations, and amended and removed corresponding provisions in the Temporary Regulations. The preamble to the 2017 Final Regulations indicated that the Treasury Department and the IRS would continue to study other issues addressed in the Temporary Regulations and the 2016 Proposed Regulations.

Executive Order 13789 (E.O. 13789), issued on April 21, 2017, instructed the Secretary to review all significant tax regulations issued on or after January 1, 2016, and to take concrete action to alleviate the burdens of regulations that (i) impose an undue financial burden on U.S. taxpayers; (ii) add undue complexity to the Federal tax laws; or (iii) exceed the statutory authority of the IRS. E.O. 13789 further instructed the Secretary to submit to the President within 60 days an interim report identifying regulations that meet these criteria.

Notice 2017-38 (2017-30 I.R.B. 147 (July 24, 2017)) included the Temporary Regulations in a list of eight regulations identified by the Secretary in the interim report as meeting at least one of the first two criteria specified in E.O. 13789. In particular, Notice 2017-38 mentioned a concern raised by commenters that the Temporary Regulations "could result in over-inclusion of gain in some cases, particularly where a large corporation acquires a small corporation that engaged in a Section 355 spinoff and the large corporation subsequently makes a REIT election." *See also* Executive Order 13789—Second Report to the President on Identifying and Reducing Tax Regulatory Burdens (Second Report), 82 FR 48013 (October 16, 2017) (stating that the Treasury Department and the IRS "agree that the temporary regulations may produce inappropriate results in some cases"). In response to comments received addressing the Temporary Regulations and the 2016 Proposed Regulations, the Treasury Department and the IRS published a notice of proposed rulemaking (REG-113943-17) addressing the potential over-inclusion of gain in the **Federal Register** (84 FR 11259) on March 26, 2019 (2019 Proposed Regulations). A correction to the 2019 Proposed Regulations was published in the **Federal Register** (84 FR 18999) on May 3, 2019. One substantive comment was received in response to the 2019 Proposed Regulations.

Summary of Comments and Explanation of Revisions

This Summary of Comments and Explanation of Revisions discusses the comments received in response to the 2016 Proposed Regulations, Notice 2017-38, and the 2019 Proposed Regulations. However, certain comments received in response to the 2016 Proposed Regulations and Notice 2017-38 were addressed in the Explanation of Provisions in the preamble to the 2019 Proposed Regulations and are not repeated in this Summary of Comments and Explanation of Revisions.

I. *Consideration of Limitation for Planned Transactions*

Under proposed §1.337(d)-7(c)(6), a C corporation described in paragraph (f)(1) of that section would be treated as having made an election under §1.337(d)-7(c)(5) (deemed sale election) with respect to a conversion transaction if (i) the conversion transaction occurs following a related section 355 distribution (as defined in paragraph (f)(1)(i) of that section), and (ii) the C corporation has not made such election (automatic deemed sale rule). Proposed §1.337(d)-7(f)(1) would provide that the automatic deemed sale rule (or the corresponding rule in paragraph (b)(4) of that section) applies to a C corporation if (i) the C corporation engages in a conversion transaction involving a REIT during the twenty-year period beginning on the date that is ten years before the date of a related section 355 distribution and (ii) the C corporation engaging in the related section 355 distribution is either the distributing corporation or the controlled corporation (as those terms are defined in section 355(a)(1)), or a member of the separate affiliated group (as defined in section 355(b)(3)(B)) (SAG) of the distributing corporation or the controlled corporation. A conversion transaction occurs through (i) the qualification of a C corporation as a RIC or a REIT, or (ii) the transfer of property owned by a C corporation to a RIC or a REIT. Section 1.337(d)-7(a)(2)(ii).

One commenter recommended that the automatic deemed sale rule apply only if the conversion transaction and the related section 355 distribution are carried out as part of the same plan. To facilitate the identification of such a plan, the commenter requested a two-year presumption rule. Under that rule, (i) a conversion transaction completed within two years of a related section 355 distribution would be presumed to have been carried out as part of a plan that included the related section 355 distribution, and (ii) a conversion transaction not completed within two years of a related section 355 distribution would be presumed not to have been carried out as part of such a plan. The commenter also recommended additional provisions similar to the section 355(e) safe harbor rules and the section 707(a)(2)(B) disguised sale rules.

The Treasury Department and the IRS agree that the automatic deemed sale rule could apply to a conversion transaction and related section 355 distribution carried out as part of the same plan, but they have determined that the text and purposes of sections 355(h) and 856(c)(8) do not require the existence of a plan. Those provisions, as added by section 311 of the PATH Act, enacted as Division Q of the Consolidated Appropriations Act, 2016, Public Law 114-113 (129 Stat. 2422), prevent the circumvention of *General Utilities* repeal and apply without regard to the existence of a plan that includes both a related section 355 distribution and a conversion transaction. Under section 355(h), a distribution of the stock of a controlled corporation does not qualify for tax-free treatment under section 355(a) if either the distributing corporation or the controlled corporation (but not both) is a REIT. The section 856(c)(8) limitation on eligibility for REIT elections focuses on the ten-year period (rather than a two-year period) beginning on the date of a distribution to which section 355 (or so much of section 356 as relates to section 355) applies. In addition, the Treasury Department and the IRS have determined that the introduction of a plan concept (as well as the recommended safe harbor and anti-abuse rules) into the automatic deemed sale rule would substantially increase the rule's complexity, and thereby reduce its effectiveness and predictability.

II. *Time Period between Conversion Transaction and Related Section 355 Distribution*

As described in part I of this Summary of Comments and Explanation of Revisions, application of the automatic deemed sale rule depends in part on whether a C corporation engages in a conversion transaction involving a REIT during the twenty-year period beginning on the date that is ten years before the date of a related section 355 distribution. *See* proposed §1.337(d)-7(c)(6). A commenter requested that these final regulations reduce that twenty-year period to a ten-year period. The commenter relied upon §1.337(d)-7(b)(2)(iii), which incorporates the five-year recognition period described in section 1374(d)(7)(A) specifically for purposes of applying the rules of section 1374 and the regulations thereunder. The commenter noted that the PATH Act had reduced the ten-year period historically required under section 1374(d)(7)(A) to the current five-year period, and asserted that the automatic deemed sale rule should employ a five-year recognition period, both before and after a related section 355 distribution, to maintain consistency with the recognition rules specific to section 1374.

The Treasury Department and the IRS recognize the commenter's preference for consistency. However, they have concluded that section 1374 treatment does not adequately implement the purposes of *General Utilities* repeal if a taxpayer effects a tax-free separation of REIT-qualifying assets from non-qualifying assets in a section 355 distribution and the REIT-qualifying assets become the assets of a REIT. *See* preamble to the Temporary Regulations (81 FR at 36795). As an example, the REIT and its shareholders may realize the benefit of appreciation on converted property without a transaction that is taxable at the corporate level. *See id*. at 36795-6. Moreover, without a section 355 distribution, a taxpayer generally could not separate REIT-qualifying assets from non-qualifying assets and cause one corporation to hold the REIT-qualifying assets and another corporation to hold the non-qualifying assets except by means of a taxable transaction. *See id*. at 36796. Consequently, the Treasury Department and the IRS have concluded that a five-year recognition period provided specifically for section 1374 and its underlying regulations should not affect the length of the recognition period for the automatic deemed sale rule.

The Treasury Department and the IRS have concluded that the ten-year eligibility limitation regarding REIT elections under section 856(c)(8) provides a more appropriate safeguard for *General Utilities* repeal, and supports the twenty-year recognition period in proposed §1.337(d)-7(f)(1)(i). In general, section 856(c)(8) provides that a corporation may not elect REIT status during the ten-year period following a distribution qualifying under section 355 if such corporation was the distributing corporation or the controlled corporation in that distribution. When describing existing law prior to the enactment of section 856(c)(8), the staff of the Joint Committee on Taxation observed that, following a section 355 distribution, "income from the assets held in the REIT is no longer subject to corporate level tax (unless there is a disposition of such assets that incurs tax under the built in gain rules)." *See* Staff, Joint Committee on Taxation, Technical Explanation of the Protecting Americans from Tax Hikes Act of 2015, House Amendment #2 to the Senate Amendment to H.R. 2029, JCX-144-15, at 170 (2015). Consequently, to ensure the continuing integrity of *General Utilities* repeal, the Treasury Department and the IRS have concluded that the twenty-year period described in proposed §1.337(d)-7(f)(1)(i) would provide a more appropriate recognition period.

III. *Application of Automatic Deemed Sale Rule to Predecessors and Successors*

Proposed §1.337(d)-7(f)(2) would provide that, for purposes of identifying C corporations to which the automatic deemed sale rule could apply, "any reference to a controlled corporation or a distributing corporation includes a reference to any predecessor or successor of such corporation." The terms "predecessor" and "successor" would "include corporations which succeed to and take into account items described in section 381(c) of the distributing corporation or the controlled corporation, and corporations having such items to which the distributing corporation or the controlled corporation succeeded and took into account." Proposed §1.337(d)-7(f)(2). Commenters have expressed concern that the word "include" will create uncertainty regarding the scope of the terms "predecessor" and "successor" and consequently would cause difficulties in performing due diligence. As a result, these commenters have requested that the word "include" be clarified or otherwise limited.

The Treasury Department and the IRS acknowledge these concerns, particularly those regarding due diligence burdens, but have determined that proposed §1.337(d)-7(f)(2) strikes an appropriate balance between providing sufficiently predictable application of the automatic deemed sale rule and preventing avoidance of that rule. The application of predecessor and successor concepts to distributing corporations and controlled corporations in the 2016 Proposed Regulations, extended to members of the SAGs of those corporations in the 2019 Proposed Regulations, limits the potential avoidance of the automatic deemed sale rule. The Treasury Department and the IRS have determined that the language of proposed §1.337(d)-7(f)(2) will provide sufficient certainty regarding the scope of the terms "predecessor" and "successor," particularly in light of the 2019 Proposed Regulations' policy of ensuring that gain will be recognized "only on property that is traceable to the section 355 distribution." Preamble to 2019 Proposed Regulations (84 FR 11261). Moreover, the distribution property limitation will reduce uncertainty as to the consequences of a determination that a corporation is a predecessor or successor.

IV. *Application to SAG Members of Distributing and Controlled Corporations*

One commenter contended that the 2016 Proposed Regulations should not apply to a member of the SAG of the distributing corporation or the controlled corporation because corporate-level taxation would not be avoided in such a situation unless the stock of the SAG member itself were distributed in a section 355 distribution. The Treasury Department and the IRS have determined that corporate-level taxation could be avoided regardless of whether the stock of the SAG member were distributed.

As an example, a distributing corporation owns all of the stock of a controlled corporation, the sole assets of which consist of all of the stock in a subsidiary that owns only real estate assets. The distributing corporation distributes all of the controlled corporation stock in a distribution qualifying under section 355. Within ten years thereafter, the subsidiary elects REIT status. During the year following the election, the controlled corporation merges downstream into the subsidiary in a reorganization described in section 368(a), with the subsidiary surviving. Section 856(c)(8) would not apply to that transaction because the subsidiary was not a distributing corporation, a controlled corporation, or a successor to either corporation at the time of the REIT election (although the subsidiary subsequently becomes a successor to the controlled corporation as a result of the merger). Accordingly, the Treasury Department and the IRS have determined that the application of the automatic deemed sale rule to SAG members of the distributing corporation or a controlled corporation would further the intent of Congress to prevent avoidance of *General Utilities* repeal.

V. *Scope of, and Exclusions to, the Automatic Deemed Sale Rule*

A. Two-Year Requirement for Post-Distribution Distributing and Controlled REITs

Proposed §1.337(d)-7(f)(3)(i) would preclude application of the automatic deemed sale rule if the distributing corporation and the controlled corporation are both REITs immediately after the related section 355 distribution and at all times during the two-year period thereafter. Commenters have requested the elimination of the two-year requirement.

The Treasury Department and the IRS have concluded, however, that the two-year requirement would appropriately limit potential avoidance of proposed §1.337(d)-7(f)(3)(i). The two-year requirement is designed to protect the purposes of the PATH Act, and therefore *General Utilities* repeal, by ensuring that distributing corporations and controlled corporations that pursue the exception provided by section 355(h)(2)(A) continue to operate for a substantial duration as REITs. The Treasury Department and the IRS acknowledge concerns raised by commenters regarding the risk of inadvertent terminations of REIT status during this initial two-year period. However, section 856 provides opportunities for a REIT to cure an inadvertent technical failure to comply with that section's requirements without loss of REIT status. *See*, for example, sections 856(c)(6), (c)(7), and (g)(5) (election of REIT status terminates for failure to meet REIT requirements unless failure is due to reasonable cause and not due to willful neglect). Consequently, the Treasury Department and the IRS do not believe that the two-year requirement would cause the distributing corporation or the controlled corporation to recognize gain as a result of inadvertent noncompliance.

B. Consideration of Exclusion Involving REITs and Qualified REIT Subsidiaries

A commenter requested that the automatic deemed sale rule not apply to certain section 355 distributions within corporate groups, after which the corporate parent of the distributing corporation and the controlled corporation elects REIT status, and the distributing corporation, the controlled corporation, or both become qualified REIT subsidiaries (QRS).

The Treasury Department and the IRS decline to adopt this proposed exception to the automatic deemed sale rule based on the determination that such exception would create opportunities for circumventing *General Utilities* repeal. For example, a section 355 distribution of a controlled corporation that will be a QRS following the parent's election of REIT status could be used to reduce the value of the distributing corporation in order for such corporation to be a taxable REIT subsidiary following its parent's election of REIT status, even though, without such a reduction, the value of the distributing corporation would cause the parent to fail the requirement of section 856(c)(4)(B)(ii). In addition, the Treasury Department and the IRS note that, if the distributing corporation or the controlled corporation had liquidated (or had been deemed to liquidate) prior to the parent's REIT election, the parent would be a successor to the liquidated corporation and therefore ineligible to elect REIT status as a result of section 856(c)(8).

C. Consideration of Knowledge Standard for Automatic Deemed Sale Rule

A commenter requested the incorporation of a knowledge standard into the automatic deemed sale rule. Specifically, the commenter recommended that the automatic deemed sale rule should not apply to a REIT that receives property from a C corporation if the REIT (i) receives a representation that the C corporation (including specified predecessors and SAG members) has not engaged in a related section 355 distribution, and (ii) has no actual knowledge contrary to such representation. The commenter contended that, without a knowledge component, the level of diligence necessary to apply the automatic deemed sale rule could prove burdensome (for example, in situations that involve predecessors of SAG members or significant time lapses between relevant transactions). For similar reasons, the commenter asserted that the absence of a knowledge component could limit the practical utility of the distribution property limitation under proposed §1.337(d)-7(c)(6)(ii), which would require the REIT to establish through such diligence that a subject property is not distribution property.

The Treasury Department and the IRS acknowledge the concerns expressed by the commenter, but have decided not to adopt this recommendation. The Treasury Department and the IRS have concluded that adoption of a knowledge component would reduce, rather than increase, certainty regarding the application of the automatic deemed sale rule because a knowledge component would inject subjectivity into the rule. Moreover, as the commenter noted, REITs ordinarily undertake extensive due diligence in connection with corporate transactions, such as mergers with C corporations, to ensure that the transaction will not terminate REIT status. For example, a REIT would routinely conduct an earnings and profits study of the C corporation. As a result, the Treasury Department and the IRS believe that REITs generally will possess adequate data to determine the appropriate tax consequences of a conversion transaction and make use of the distribution property limitation, particularly because this limitation will apply on a property-by-property basis and thereby apply even if a REIT possesses incomplete records. In addition, a contemporaneous documentation of property owned at the time of a related section 355 distribution generally will provide sufficient records for establishing that any property not listed in such documentation is not distribution property.

VI. *Definition of the Term "Converted Property"*

The 2016 Proposed Regulations would define the term "converted property" as "property owned by a C corporation that becomes the property of a RIC or a REIT and any other property the basis of which is determined, directly or indirectly, in whole or in part, by reference to the basis of the property owned by a C corporation that becomes the property of a RIC or a REIT." Proposed §1.337(d)-7(a)(2)(vii). A commenter requested that the definition be clarified to confirm the commenter's interpretation that the phrase "any other property" refers only to property of a RIC or a REIT. The Treasury Department and the IRS agree with the commenter's interpretation and have clarified the definition accordingly.

VII. *Interaction of 2016 Proposed Regulations with Section 856(c)(8)*

A commenter inquired whether the Treasury Department or the IRS intended the 2016 Proposed Regulations to override section 856(c)(8) (described in part I of this Summary of Comments and Explanation of Revisions). The 2016 Proposed Regulations do not override section 856(c)(8). Accordingly, if section 856(c)

(8) would prevent a distributing corporation or a controlled corporation from electing REIT status, no gain would be recognized, absent further action (for example, a merger of the distributing corporation or the controlled corporation into a REIT).

VIII. *Application of 2016 Proposed Regulations to RICs*

The Treasury Department and the IRS requested comments on whether the rules set forth in the 2016 Proposed Regulations (other than the definition of the term "converted property") should apply to RICs. No recommendations were received in response to this request. The Treasury Department and the IRS have not become aware of a need to extend the rules to RICs and therefore decline to extend such rules to RICs at this time.

Effective/applicability dates

The 2019 proposed regulations included a proposal to issue the final rule with a 30-day delayed effective date. The Treasury Department and the IRS have concluded, however, that a 30-day delay in the effective date of these final regulations would be unnecessary and contrary to public interest. Specifically, the Treasury Department and the IRS have determined that any duration between the expiration of the Temporary Regulations and the effective date of these final regulations could cause significant confusion regarding the current state of the law. In addition, the Treasury Department and the IRS have concluded that the benefit of public notice ordinarily provided by such 30-day delay is significantly reduced in this particular instance because these final regulations adopt the proposed regulations without substantive change. In addition, the Treasury Department and the IRS note that these final regulations adopt the distribution property limitation under proposed §1.337(d)-7(c)(6)(ii), which provides an exception to the general automatic deemed sale rule.

Special Analyses

This regulation is not subject to review under section 6(b) of Executive Order 12866 pursuant to the Memorandum of Agreement (April 11, 2018) between the Treasury Department and the Office of Management and Budget regarding review of tax regulations. Pursuant to the Regulatory Flexibility Act (5 U.S.C. chapter 6), it is hereby certified that these final regulations will not have a significant economic impact on a substantial number of small entities. These final regulations would affect transactions in which property of a C corporation becomes the property of a REIT following a section 355 distribution of controlled C corporation stock. Generally, these section 355 distributions involve publicly traded C corporations, which typically are not small entities as defined by the Regulatory Flexibility Act. Transactions in which the property of such C corporation becomes the property of a REIT generally involve the transfer of all of the assets of the C corporation. Therefore, the transferee REIT likely also would not be a small entity, as defined by the Regulatory Flexibility Act. As a result, this certification is based on the conclusion that these final regulations would primarily affect large C corporations and REITs that have substantial numbers of shareholders. Therefore, a regulatory flexibility analysis is not required. Pursuant to section 7805(f) of the Code, the proposed rule preceding this final regulation was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business and no comments were received.

Drafting Information

The principal author of these regulations is Austin Diamond-Jones, Office of Associate Chief Counsel (Corporate). However, other personnel from the Treasury Department and the IRS participated in their development.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

Part 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

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

Par. 2. Section 1.337(d)-7 is amended by:

1. Revising paragraphs (a)(1) and (a)(2)(vi) through (vii).
2. Adding paragraph (a)(2)(viii).
3. Revising paragraphs (b)(4), (c)(1) and (6), (f), and (g)(2)(ii).

The revisions and additions read as follows:

§1.337(d)-7 Tax on property owned by a C corporation that becomes property of a RIC or REIT.

(a) *General rule*—(1) *Property owned by a C corporation that becomes property of a RIC or a REIT*. If property owned by a C corporation (as defined in paragraph (a)(2)(i) of this section) becomes the property of a RIC or a REIT in a conversion transaction (as defined in paragraph (a)(2)(ii) of this section), then section 1374 treatment will apply as described in paragraph (b) of this section, unless the C corporation elects, or is treated as electing, deemed sale treatment with respect to the conversion transaction as provided in paragraph (c) of this section. See paragraph (d) of this section for exceptions to this paragraph (a).

(2) * * *

(vi) *Section 355 distribution*. The term *section 355 distribution* means any distribution to which section 355 (or so much of section 356 as relates to section 355) applies, including a distribution on which the distributing corporation recognizes gain pursuant to sections 355(d) or 355(e).

(vii) *Converted property*. The term *converted property* means—

(A) Property owned by a C corporation that becomes the property of a RIC or a REIT; and

(B) Any other property of a RIC or a REIT the basis of which is determined, directly or indirectly, in whole or in part, by reference to the basis of property described in paragraph (a)(2)(vii)(A) of this section.

(viii) *Distribution property*. The term *distribution property* means—

(A) Property owned immediately after a section 355 distribution by the distributing corporation, a controlled corporation (as those terms are defined in section 355(a)(1)), or a member of a separate affiliated group (as defined in section 355(b)(3)(B)) of which the distributing corporation or a controlled corporation is the common parent (but no formulation of the step transaction doctrine will be used to determine whether property acquired after the distribution is distribution property pursuant to this paragraph (a)(2)(viii)(A)); and

(B) Property with a basis determined, directly or indirectly, in whole or in part, by reference to property described in paragraph (a)(2)(viii)(A) of this section.

(b) * * *

(4) *Section 355 distribution following a conversion transaction*—(i) *In general*. If a REIT is described in paragraph (f)(1) of this section and the related section 355 distribution (as defined in paragraph (f)(1)(i) of this section) follows a conversion transaction, then for the taxable year in which the related section 355 distribution occurs, §1.1374-2(a)(1) and (2) (as modified by paragraph (b)(2)(i) of this section) do not apply, and the REIT's net recognized built-in gain for such taxable year is the amount of its net unrealized built-in gain limitation (as defined in §1.1374-2(a)(3)) for such taxable year.

(ii) *Basis adjustment*—(A) *In general*. If a REIT recognizes gain under paragraph (b)(4)(i) of this section, the aggregate basis of the converted property held by the REIT at the end of the taxable year in which the related section 355 distribution occurs shall be increased by an amount equal to the amount of gain so recognized, increased by the amount of the REIT's recognized built-in loss for such taxable year, and reduced by the amount of the REIT's recognized built-in gain and recognized built-in gain carryover for such taxable year.

(B) *Allocation of basis increase*. The aggregate increase in basis by reason of paragraph (b)(4)(ii)(A) of this section shall be allocated among the converted property in proportion to their respective built-in gains on the date of the conversion transaction.

* * * * *

(c) *Election of deemed sale treatment*—(1) *In general*. Paragraph (b) of this section does not apply if the C corporation that qualifies as a RIC or a REIT or transfers property to a RIC or a REIT makes the election described in paragraph (c)(5) of this section or is treated as making such election under paragraph (c)(6) of this section, except to the extent permitted by paragraph (c)(6)(ii) of this section. A C corporation that makes, or that is treated as making, such an election recognizes gain and loss as if it sold the converted property to an unrelated party at fair market value on the deemed sale date (as defined in paragraph (c)(3) of this section). See paragraph (c)(4) of this section concerning limitations on the use of loss in computing gain. Paragraph (c) of this section does not apply if its application would result in the recognition of a net loss. For this purpose, net loss is the excess of aggregate losses over aggregate gains (including items of income), without regard to character.

* * * * *

(6) *Conversion transaction following a section 355 distribution*—(i) *In general*. Except as provided in paragraph (c)(6)(ii) of this section, a C corporation described in paragraph (f)(1) of this section is treated as having made the election under paragraph (c)(5) of this section with respect to a conversion transaction if the conversion transaction occurs following the related section 355 distribution (as defined in paragraph (f)(1)(i) of this section) and the C corporation has not made such an election.

(ii) *Limitation*. A C corporation treated as having made the election under paragraph (c)(5) of this section as a result of paragraph (c)(6)(i) of this section is not treated as having made the election with respect to property that the taxpayer establishes is not distribution property with respect to the related section 355 distribution. For purposes of this paragraph (c)(6)(ii), any property with an adjusted basis in excess of its fair market value as of the date of the conversion transaction will not be treated as distribution property unless the taxpayer establishes that it owned such asset immediately after the related section 355 distribution. Paragraph (b) of this section will apply to property with respect to which the taxpayer is not treated as having made the election under paragraph (c)(5) of this section as a result of this paragraph (c)(6)(ii).

* * * * *

(f) *Conversion transaction preceding or following a section 355 distribution*—(1) *In general*. A C corporation or a REIT is described in this paragraph (f)(1) if—

(i) The C corporation or the REIT engages in a conversion transaction involving a REIT during the twenty-year period beginning on the date that is ten years before the date of a section 355 distribution (the *related section 355 distribution*); and

(ii) The C corporation or the REIT engaging in the related section 355 distribution is either—

(A) The distributing corporation or the controlled corporation, as those terms are defined in section 355(a)(1); or

(B) A member of the separate affiliated group (as defined in section 355(b)(3)(B)) of the distributing corporation or the controlled corporation.

(2) *Predecessors and successors*. For purposes of this paragraph (f), any reference to a controlled corporation, a distributing corporation, or a member of the separate affiliated group of a distributing corporation or a controlled corporation includes a reference to any predecessor or successor of such corporation. Successors include corporations which succeed to and take into account items described in section 381(c) of the distributing corporation or the controlled corporation. Predecessors include corporations having such items to which the distributing corporation or the controlled corporation succeeded and took into account.

(3) *Exclusion of certain conversion transactions*. A C corporation or a REIT is not described in paragraph (f)(1) of this section if—

(i) The distributing corporation and the controlled corporation are both REITs immediately after the related section 355 distribution (including by reason of elections under section 856(c)(1) made after the related section 355 distribution that are effective before the related section 355 distribution) and at all times during the two years thereafter;

(ii) Section 355(h)(1) does not apply to the related section 355 distribution by reason of section 355(h)(2)(B); or

(iii) The related section 355 distribution occurred before December 7, 2015, or is described in a ruling request referred to in section 311(c) of Division Q of the Consolidated Appropriations Act, 2016, Public Law 114-113, 129 Stat. 2422.

(g) * * *

(2) * * *

(ii) *Conversion transactions occurring on or after June 7, 2019, and certain prior conversion transactions*. Paragraphs (a)(1), (a)(2)(vi), (vii), and (viii), (b)(4), (c)(1) and (6), and (f) of this section apply to conversion transactions occurring on or after June 7, 2019, and to conversion transactions and related section 355 distributions for which the conversion transaction occurs before, and the related section 355 distribution occurs on or after, June 7, 2019. For conversion transactions that occurred on or after June 7, 2016, and before June 7, 2019 (other than conversion transactions and related section 355 distributions for which the conversion transaction occurs before, and the related section 355 distribution occurs on or after, June 7, 2019), see §§1.337(d)-7 and 1.337(d)-7T as contained in 26 CFR part 1 in effect on April 1, 2019.

* * * * *

§1.337(d)-7T [Removed]

Par. 3. Section 1.337(d)-7T is removed.

Kirsten Wielobob,
Deputy Commissioner for Services and Enforcement.

Approved: May 29, 2019.

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

Part III.

Methods for Calculating W-2 Wages for Purposes of Section 199A(g)

Notice 2019-27

SECTION 1. PURPOSE

This notice (Notice) contains a proposed revenue procedure that provides computational guidance on methods and appropriate sources of data for calculating W-2 wages for purposes of section 199A(g) of the Internal Revenue Code and proposed §§1.199A-8 through 1.199A-12 of the Income Tax Regulations (26 CFR part 1), which are contained in a notice of proposed rulemaking (REG-118425-18) being published contemporaneously with this Notice. Specifically, this Notice provides three methods for calculating W-2 wages for purposes of section 199A(g)(1)(B)(i), which limits the amount of the deduction available to specified agricultural or horticultural cooperatives (Specified Cooperatives) under section 199A(g)(1)(A) to 50 percent of the Specified Cooperative's W-2 wages for the taxable year. The guidance contained in this notice is necessary because changes may be made to the underlying Form W-2, Wage and Tax Statement) on a more frequent basis than updates to the regulations under section 199A(g). The three methods in this Notice are substantially similar to the methods provided in Rev. Proc. 2006-47, 2006-2 C.B. 869, used to calculate W-2 wages for purposes of the section 199 deduction and provided in Rev. Proc. 2019-11, 2019-09 I.R.B. 742, used to calculate W-2 wages for purposes of the section 199A(a) deduction.

SECTION 2. BACKGROUND

Section 199A was enacted on December 22, 2017, by section 11011 of An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018, Public Law 115-97, 131 Stat. 2054, 2063 (TCJA). Parts of section 199A were amended on March 23, 2018, as if included in TCJA, by section 101 of Division T of the Consolidated Appropriations Act, 2018, Public Law 115-141, 132 Stat. 348, 1151 (2018 Act). Unless otherwise indicated, all references to section 199A are to section 199A as amended by 2018 Act. Section 199A applies to taxable years beginning after December 31, 2017, and before January 1, 2026. Section 199A(g), as amended by 2018 Act, provides that Specified Cooperatives may claim a special deduction that is substantially similar to the domestic production activities deduction under former section 199, which was repealed by the TCJA. Specifically, section 199A(g) provides a deduction for a Specified Cooperative in an amount equal to 9 percent of the lesser of qualified production activities income (QPAI) of the Specified Cooperative for the taxable year determined under section 199A(g)(3)(A), or the taxable income of the Specified Cooperative for the taxable year determined under section 199A(g)(1)(C). Section 199A(g)(1)(B)(i) limits the amount of this deduction to 50 percent of the W-2 wages of the Specified Cooperative for the taxable year.

Section 199A(g)(1)(B)(ii) provides that *W-2 wages* are determined in the same manner as under section 199A(b)(4), without regard to section 199A(b)(4)(B) (which excludes from the definition amounts not properly allocable to qualified business income for purposes of section 199A(c)(1)) and after application of section 199A(b)(5) (concerning acquisitions, dispositions, and short taxable years), except that such wages do not include any amount that is not properly allocable to domestic production gross receipts (DPGR) for purposes of section 199A(g)(3)(A). Section 199A(b)(4)(A) defines the term *W-2 wages* to mean, with respect to any person for any taxable year of such person, the amounts described in section 6051(a)(3) and (8) paid by such person with respect to employment of employees by such person during the calendar year ending during such taxable year. Proposed §1.199A-11 further defines W-2 wages for purposes of section 199A(g). The proposed revenue procedure included in this Notice would provide guidance on the methods for calculating the amount of W-2 wages (as defined in section 199A(g)(1)(B)(ii) and proposed §1.199A-11) for purposes of determining the deduction limitation in section 199A(g)(1)(B)(i). Section 1.199A-11(c) of the proposed regulations provides the Internal Revenue Service with authority to issue computational guidance providing the methods that may be used for calculating W-2 wages, as defined in section 199A(g)(1)(B)(ii) and proposed §1.199A-11(c).

SECTION 3. REQUEST FOR COMMENTS

The Department of the Treasury (Treasury Department) and the Internal Revenue Service (IRS) request comments on the proposed revenue procedure contained in this Notice. All materials submitted will be available for public inspection and copying. Public comments should be submitted no later than August 19, 2019. Comments should include a reference to Notice 2019-27. Comments may be submitted electronically via the Federal eRulemaking Portal at *www.regulations.gov* (type IRS-2019-0013 in the search field on the *www.regulations.gov* homepage to find this notice and submit comments.) Alternatively, submissions may be sent to: CC:PA:LPD:PR (Notice 2019-27), Room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, D.C., 20044. Submissions also may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (Notice 2019-27), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, N.W., Washington, D.C. 20224. All recommendations for guidance submitted by the public in response to this notice will be available for public inspection and copying in their entirety.

SECTION 4. EFFECT ON OTHER REVENUE PROCEDURES

Rev. Proc. 2006-47, 2006-2 C.B. 869, is obsoleted.

SECTION 5. EFFECTIVE DATE AND IMMEDIATE RELIANCE

This Notice is effective on June 18, 2019. The proposed revenue procedure is proposed to apply generally to taxable years ending after December 31, 2017.

Until such time that the proposed revenue procedure is published in final form, Specified Cooperatives may use the methods described in the proposed revenue procedure in calculating W-2 wages (as defined in section 199A(g)(1)(B)(ii)) for purposes of determining the limitation in section 199A(g)(1)(B)(i).

SECTION 6. DRAFTING INFORMATION

The principal authors of this Notice are Andrew Holubeck and Mikhail Zhidkov of the Office of the Associate Chief Counsel (Employee Benefits, Exempt Organizations, and Employment Taxes) and Theresa Melchiorre of the Office of the Associate Chief Counsel (Passthroughs and Special Industries). However, other personnel from the Treasury Department and the IRS participated in its development. For further information regarding this Notice, contact Andrew Holubeck or Mikhail Zhidkov at (202) 317-4774, or James Holmes at (202) 317-4137 (not toll-free numbers).

SECTION 7. FORM OF PROPOSED REVENUE PROCEDURE

Set forth below is the form of the proposed revenue procedure that is proposed in this Notice:

FORM OF PROPOSED REVENUE PROCEDURE

Part III

Administrative, Procedural, and Miscellaneous

26 CFR 1.199A-11: Wage limitation for the section 199A(g) deduction

(Also: [XX, XXX, XXX])

Rev. Proc. 2019-XX

SECTION 1. PURPOSE

This revenue procedure provides methods for calculating W-2 wages as defined in section 199A(g)(1)(B)(ii) and §1.199A-11 of the Income Tax Regulations for purposes of the W-2 wage limitation provided in section 199A(g)(1)(B)(i) of the Internal Revenue Code. Specified agricultural or horticultural cooperatives (Specified Cooperatives) are permitted a deduction under section 199A(g)(1)(A) equal to the lesser of 9 percent of qualified production activities income (QPAI) or taxable income of a Specified Cooperative, but not to exceed the W-2 wage limitation.

SECTION 2. BACKGROUND

Section 199A(g)(1)(B)(i) limits the amount of the deduction under section 199A(g)(1)(A) to 50 percent of the W-2 wages of the Specified Cooperative (as defined in §1.199A-8(a)(2)) for the taxable year. Section 199A(g)(1)(B)(ii) provides that *W-2 wages* are determined in the same manner as under section 199A(b)(4), without regard to section 199A(b)(4)(B) (which excludes from the definition amounts not properly allocable to qualified business income for purposes of section 199A(c)(1)) and after application of section 199A(b)(5) (concerning acquisitions, dispositions, and short taxable years), except that such wages do not include any amount which is not properly allocable to domestic production gross receipts (DPGR) for purposes of section 199A(g)(3)(A).

Section 199A(b)(4)(A) defines the term *W-2 wages* to mean, with respect to any person for any taxable year of such person, the amounts described in section 6051(a)(3) and (8) paid by such person with respect to employment of employees by such person during the calendar year ending during such taxable year. Section 199A(b)(4)(C) provides that W-2 wages shall not include any amount that is not properly included in a return filed with the Social Security Administration (SSA) on or before the 60th day after the due date (including extensions) for such return.

Section 1.199A-11(c) of the regulations provides the Internal Revenue Service with authority to issue guidance providing computational methods that may be used to calculate W-2 wages.

This revenue procedure provides three methods for calculating W-2 wages (as defined in section 199A(g)(1)(B)(ii) and §1.199A-11) for purposes of section 199A(g) and the regulations thereunder. The first method (the unmodified Box method) allows for a simplified calculation, while the second and third methods (the modified Box 1 method and the tracking wages method) provide greater accuracy.

W-2 wages calculated under this revenue procedure are not necessarily the W-2 wages that are properly allocable to DPGR and eligible for use in computing the section 199A(g) limitations. Under §1.199A-8(b)(5)(ii)(*B*) a Specified Cooperative that is not qualified as a farmer's cooperative organization under section 521 (nonexempt Specified Cooperative) must use only patronage W-2 wages that are properly allocable to patronage DPGR to compute its section 199A(g)(1)(B)(i) W-2 wage limitation. Under §1.199A-8(c)(2) a Specified Cooperative that is qualified as a farmer's cooperative organization under section 521 (exempt Specified Cooperative) must calculate separate patronage and nonpatronage deductions under section 199A(g)(1)(A) and apply separate patronage and nonpatronage W-2 wage limitations. Under §1.199A-11(b)(2) the Specified Cooperative must determine the amount of wages that is properly allocable to DPGR for purposes of calculating QPAI (as defined in section 199A(g)(3)(A)). The Specified Cooperative may use any reasonable method that is satisfactory to the Secretary based on all of the facts and circumstances. The chosen reasonable method must be consistently applied from one taxable year to another and must clearly reflect the wages allocable to DPGR for purposes of QPAI. The books and records maintained for wages allocable to DPGR for purposes of QPAI must be consistent with any allocations. Then, the amount of W-2 wages that are properly allocable to DPGR is used in determining the W-2 wage limitation under section 199A(g)(1)(B)(i) as determined under §1.199A-8(b)(5)(ii)(*B*) or §1.199A-8(c)(2) depending upon whether the Specified Cooperative is nonexempt or exempt, respectively.

SECTION 3. RULES OF APPLICATION

.01 *In general*. In calculating W-2 wages for a taxable year under the methods described in this revenue procedure, include only wages properly reported on Forms W-2 that meet the applicable rules of §1.199A-11(a), §1.199A-8(b)(5)(ii)(B), and §1.199A-8(c)(2), as applicable. Specifically, §1.199A-11(a)(2) provides that, except as provided in §1.199A-11(d)(2)) (concerning short taxable years that do not include December 31), the Forms W-2, Wage and Tax Statement, or any subsequent form or document used in determining the amount of W-2 wages are those issued for the calendar year ending during the taxable year of the Specified Cooperative for wages paid to employees (or former employees) of the Specified Cooperative for employment by the Specified Cooperative. Section 1.199A-11(a)(1) also provides that, for purposes of §1.199A-11, employees of the Specified Cooperative are limited to employees of such Specified Cooperative as defined in section 3121(d)(1) and (2) (that is, officers of a corporate taxpayer and employees of the taxpayer under the common law rules). Therefore, Forms W-2 provided to statutory employees described in section 3121(d)(3) (that is, Forms W-2 in which the "Statutory Employee" box in Box 13 is checked) should not be included in calculating W-2 wages under any of the methods described in this revenue procedure.

.02 *No application in determining whether amounts are wages for employment tax purposes*. The discussions of "wages" in this revenue procedure and in the regulations under section 199A(g) are for purposes of section 199A(g) only and have no application in determining whether amounts are wages under section 3121(a) for purposes of the Federal Insurance Contributions Act, under section 3306(b) for purposes of the Federal Unemployment Tax Act, or under section 3401(a) for purposes of the Collection of Income Tax at Source on Wages (federal income tax withholding), or any other wage-related determination. *See* §1.199A-11(a)(1) of the regulations.

SECTION 4. DEFINITION OF W-2 WAGES AND CORRELATION WITH BOXES ON FORM W-2

.01 *Definition of W-2 wages.* Section 199A(g)(1)(B)(ii) provides that *W-2 wages* are determined in the same manner as under section 199A(b)(4) (without regard to section 199A(b)(4)(B)). Section 199A(b)(4)(A) provides that W-2 wages means, with respect to any person for any taxable year of such person, the sum of the amounts described in section 6051(a)(3) and (8) paid by such person with respect to employment of employees by such person during the calendar year ending during such taxable year. Thus, as also provided in §1.199A-11(b)(1), W-2 wages include: (i) the total amount of wages (as defined in section 3401(a)); (ii) the total amount of elective deferrals (within the meaning of section 402(g)(3)); (iii) the compensation deferred under section 457; and (iv) the amount of designated Roth contributions (as defined in section 402A).

.02 *Correlation with Form W-2.* On the 2018 Forms W-2, the elective deferrals under section 402(g)(3) and the amounts deferred under section 457 directly correlate to coded items reported in Box 12 on Form W-2. Box 12, Code D is for elective deferrals to a section 401(k) cash or deferred arrangement plan (including a SIMPLE 401(k) arrangement); Box 12, Code E is for elective deferrals under a section 403(b) salary reduction agreement; Box 12, Code F is for elective deferrals under a section 408(k)(6) salary reduction Simplified Employee Pension (SEP); Box 12, Code G is for elective deferrals and employer contributions (including nonelective deferrals) to any governmental or nongovernmental section 457(b) deferred compensation plan; Box 12, Code S is for employee salary reduction contributions under a section 408(p) SIMPLE (simple retirement account); Box 12, Code AA is for designated Roth contributions (as defined in section 402A) under a section 401(k) plan; and Box 12, Code BB is for designated Roth contributions (as defined in section 402A) under a section 403(b) salary reduction agreement. However, designated Roth contributions are also reported in Box 1, wages, tips, other compensation and are subject to income tax withholding.

SECTION 5. METHODS FOR CALCULATING W-2 WAGES

For any taxable year, a Specified Cooperative must calculate W-2 wages for purposes of section 199A(g)(1)(B)(i) using one of the three methods described in section 5.01, 5.02, and 5.03 of this revenue procedure. For a Specified Cooperative with a short taxable year, see section 6 of this revenue procedure. In calculating W-2 wages for a taxable year under the methods below, the Specified Cooperative includes only those Forms W-2 that are for the calendar year ending with or within the taxable year of the Specified Cooperative and that meet the rules of application described in section 3 of this revenue procedure.

.01 *Unmodified Box method*. Under the unmodified Box method, W-2 wages are calculated by taking, without modification, the lesser of—

(A) The total entries in Box 1; or

(B) The total entries in Box 5

of all Forms W-2 filed with SSA by the Specified Cooperative with respect to employees of the Specified Cooperative for employment by the Specified Cooperative.

.02 *Modified Box 1 method*. Under the modified Box 1 method, the Specified Cooperative makes modifications to the total entries in Box 1 of Forms W-2 filed with respect to employees of the Specified Cooperative. W-2 wages under this method are calculated as follows—

(A) Total the amounts in Box 1 of all Forms W-2 filed with SSA by the Specified Cooperative with respect to employees of the Specified Cooperative for employment by the Specified Cooperative;

(B) Subtract from the total in paragraph .02(A) of this section amounts included in Box 1 of Forms W-2 that are not wages for Federal income tax withholding purposes, including amounts that are treated as wages for purposes of income tax withholding under section 3402(o) (for example, supplemental unemployment compensation benefits within the meaning of Rev. Rul. 90-72, 1990-2 C.B. 211); and

(C) Add to the amount obtained after paragraph .02(B) of this section the total of the amounts that are reported in Box 12 of Forms W-2 with respect to employees of the Specified Cooperative for employment by the Specified Cooperative and that are properly coded D, E, F, G, or S.

.03 *Tracking wages method*. Under the tracking wages method, the Specified Cooperative actually tracks total wages subject to Federal income tax withholding and makes appropriate modifications. W-2 wages under this method are calculated as follows—

(A) Total the amounts of wages subject to Federal income tax withholding that are paid to employees of the Specified Cooperative for employment by the Specified Cooperative and that are reported on Forms W-2 filed with SSA by the Specified Cooperative for the calendar year; and

(B) Add to the amount obtained after paragraph .03(A) of this section the total of the amounts that are reported in Box 12 of Forms W-2 with respect to employees of the Specified Cooperative for employment by the Specified Cooperative and that are properly coded D, E, F, G, or S.

SECTION 6. APPLICATION IN CASE OF SHORT TAXABLE YEAR

.01 *Special rule for Specified Cooperative with a short taxable year.* In the case of a Specified Cooperative with a short taxable year, subject to the rules of application described in section 3 of this revenue procedure, the W-2 wages of the Specified Cooperative for the short taxable year shall include only those wages paid during the short taxable year to employees of the Specified Cooperative, only those elective deferrals (within the meaning of section 402(g)(3)) made during the short taxable year by employees of the Specified Cooperative, and only compensation actually deferred under section 457 during the short taxable year with respect to employees of the Specified Cooperative. See §1.199A-11(e) of the regulations.

.02 *Method required for a short taxable year and modifications required in application of method.* The W-2 wages of a Specified Cooperative with a short taxable year shall be determined under the tracking wages method described in section 5.03 of this revenue procedure. In applying the tracking wages method in the case of a short taxable year, the Specified Cooperative must apply the method as follows—

(A) For purposes of section 5.03(A), the total amount of wages subject to Federal income tax withholding and reported on Form W-2 must include only those wages subject to Federal income tax withholding that are actually or constructively paid to employees during the short taxable year and reported on Form W-2 for the calendar year ending with or within that short taxable year (or, for a short taxable year that does not contain a calendar year ending with or within such short taxable year, wages subject to Federal income tax withholding that are actually or constructively paid to employees during the short taxable year and reported on Form W-2 for the calendar year containing such short taxable year); and

(B) For purposes of section 5.03(B), only the portion of the total amounts reported in Box 12, Codes D, E, F, G, or S on Forms W-2, that are actually deferred or contributed during the short taxable year are included in W-2 wages.

SECTION 7. EFFECTIVE DATE

This revenue procedure applies to taxable years ending after December 31, 2017.

SECTION 8. DRAFTING INFORMATION

The principal authors of this revenue procedure are Andrew Holubeck and Mikhail Zhidkov of the Office of the Associate Chief Counsel (Tax Exempt and Government Entities) and Theresa Melchiorre of the Office of the Associate Chief Counsel (Passthroughs & Special Industries). However, other personnel from the Department of the Treasury and the Internal Revenue Service participated in its development. For further information regarding this revenue procedure contact Andrew Holubeck or Mikhail Zhidkov at (202) 317-4774, or James Holmes at (202) 317-4137 (not toll-free numbers).

Beginning of Construction for Sections 45 and 48; Tolling and Extension of Continuity Safe Harbor to Mitigate Significant National Security Concerns

Notice 2019-43

SECTION 1. PURPOSE

This notice modifies the guidance provided in Notice 2013-29, 2013-1 C.B. 1085; Notice 2013-60, 2013-2 C.B. 431; Notice 2014-46, 2014-2 C.B. 520; Notice 2015-25, 2015-13 I.R.B. 814; Notice 2016-31, 2016-23 I.R.B. 1025; Notice 2017-04, 2017-4 I.R.B. 541; and Notice 2018-59, 2018-28 I.R.B. 196 (collectively, the prior IRS notices) to provide that the continuity safe harbor (as defined below) may be tolled and extended in certain limited circumstances involving significant national security concerns.

SECTION 2. BACKGROUND

Section 38 of the Internal Revenue Code (the Code) allows certain business credits against the tax imposed by Chapter 1 of the Code. Among the credits allowed by § 38 are the investment credit determined under § 46 and the renewable electricity production credit under § 45(a). The investment credit includes the energy credit under § 48. The credits under §§ 45(a) and 48 generally are referred to as the production tax credit (PTC) and the investment tax credit (ITC), respectively.

To qualify for the PTC, electricity must, among other things, be produced by the taxpayer at a qualified facility as defined in § 45(d). The PTC for any taxable year is calculated by multiplying an inflation-adjusted credit rate by kilowatt hours of electricity produced and sold by the taxpayer to an unrelated person. The ITC is calculated as a percentage of the basis of energy property, as defined in § 48(a)(3), placed in service during the taxable year. A taxpayer may elect under § 48(a)(5) to treat a certain qualified facilities under § 45(d) as energy property and claim the ITC rather than the PTC with respect to the facility.

On December 18, 2015, the Consolidated Appropriations Act, 2016, Pub. L. No. 114-113, Div. P and Q, 129 Stat. 2242, (CAA) enacted amendments to the PTC and the ITC for certain renewable energy facilities and energy properties. The CAA extended the PTC for two years with respect to certain facilities the construction of which began before January 1, 2017, and further extended the PTC for wind facilities the construction of which begins before January 1, 2020. The CAA also modified the PTC for wind facilities by providing that the credit will phase out over four years and extended the election to claim the ITC in lieu of the PTC with respect to certain renewable energy facilities if construction of such facility began before January 1, 2017 (or January 1, 2020, in the case of wind facilities).

On February 9, 2018, the Bipartisan Budget Act of 2018, Pub. L. 115-123, Div. D, 132 Stat. 64, (BBA) modified the ITC under § 48 by replacing the requirement to place energy property in service by a certain date with a requirement to begin construction by a certain later date. As modified, construction of energy property must begin before January 1, 2022. This modification has the effect of retroactively extending by five years the ITC for fiber-optic solar energy property, qualified fuel cell property, qualified microturbine property, combined heat and power system property, qualified small wind energy property, and geothermal heat pump property the construction of which begins before January 1, 2022. The BBA amendments also phase out the ITC for fiber-optic solar energy property, qualified fuel cell property, and qualified small wind energy property over five years. For these energy properties, regardless of when construction begins, the projects must be placed in service before January 1, 2024.

Notice 2013-29 provides two methods to establish beginning of construction under § 45: starting physical work of a significant nature or incurring five percent or more of the total cost of the facility. Both methods require a taxpayer to make continuous progress towards completion once construction has begun (under either the Continuous Construction Test of section 4.06 or the Continuous Efforts Test of section 5.02 of Notice 2013-29).

Notice 2013-60 provides a safe harbor (Continuity Safe Harbor) that allows a taxpayer to be deemed to satisfy the Continuous Construction Test or the Continuous Efforts Test based on the date the facility is placed in service. If a facility is not placed in service before the required date, whether the facility satisfies the Continuous Construction or Continuous Efforts Tests is determined by the relevant facts and circumstances.

Section 3 of Notice 2016-31 modifies and extends the Continuity Safe Harbor by providing that if a taxpayer places a facility in service by the later of (1) a calendar year that is no more than four calendar years after the calendar year during which construction of the facility began or (2) December 31, 2016, the facility will be considered to satisfy the Continuity Safe Harbor.

Section 3 of Notice 2017-04 further modifies and extends the Continuity Safe Harbor by providing that if a taxpayer places a facility in service by the later of (1) a calendar year that is no more than four calendar years after the calendar year during which construction of the facility began or (2) December 31, 2018, the facility will be considered to satisfy the Continuity Safe Harbor.

For purposes of the beginning of construction requirement under § 48, section 6.05 of Notice 2018-59 also provides a Continuity Safe Harbor. If a taxpayer places energy property in service by the end of a calendar year that is no more than four calendar years after the calendar year during which construction of the energy property began, the energy property will be considered to satisfy the Continuity Safe Harbor.

A plan to develop or construct a facility or energy property (Plan) includes the construction of the electricity generating equipment, but may also include the construction or installation of additional equipment that is not part of the facility or energy property itself but which is necessary to connect the facility or energy property to the energy grid or to customers (including, but not limited to, a distribution or transmission line or other interconnection equipment).

The Treasury Department and the Internal Revenue Service recognize that, in some situations, a Plan may raise significant national security concerns for the Department of Defense (DOD). Any efforts to mitigate these significant national security concerns by pursuing a modification to the Plan may delay the development and construction of the facility or energy property. This notice therefore provides that, with respect to any Plan that satisfies the requirements provided in section 3.01, the Continuity Safe Harbor may be tolled and extended in certain limited circumstances involving significant national security concerns. Except as otherwise specified in this notice, the guidance provided in the prior IRS notices continues to apply.

SECTION 3. TOLLING AND EXTENSION OF THE CONTINUITY SAFE HARBOR

.01 *Tolling and Extension of Continuity Safe Harbor To Mitigate Significant National Security Concerns*. This notice provides that if all of the requirements set forth in this section 3.01 are satisfied, for purposes of §§ 45 and 48, the Continuity Safe Harbor will be tolled and extended for a period of time to account for delays that result from pursuing a modification to a Plan to mitigate significant national security concerns raised by the DOD (Tolling Period). On the date that the Tolling Period ends the Continuity Safe Harbor resumes. The Continuity Safe Harbor will be tolled and extended if all of the following requirements are satisfied:

(1) Construction has begun (within the meaning of the prior IRS notices) with respect to the facility or energy property that will generate the credits under §§ 45 or 48 pursuant to the Plan;

(2) Parties holding an ownership interest in property that is part of the Plan (or that will hold an ownership interest in property that is part of the Plan after such property is constructed), including (a) the facility or energy property, or (b) the additional equipment that is not part of the facility or energy property itself but which is necessary to connect the facility or energy property to the energy grid or to customers (including, but not limited to, a distribution or a transmission line or

other interconnection equipment) have received one or more government permits or approvals necessary to implement the Plan;

(3) The DOD provides written notice directly to one or more of the parties described in paragraph (2) of this section 3.01 that one or more aspects of the Plan raises significant concerns related to national security and that modification of the Plan would be in the best interests of national security objectives;

(4) Such parties pursue a modification of the Plan acceptable to DOD to mitigate these significant national security concerns and to further the national security objectives; and

(5) The modification of the Plan requires the parties to obtain new or additional permits or licenses, which delays placing the facility or energy property in service.

.02 *Calculation of Tolling Period*. The Tolling Period will result in a day-for-day extension of the Continuity Safe Harbor. The first day of the Tolling Period is the date on which the DOD provides the written notice described in requirement (3) of section 3.01 of this notice. The last day of the Tolling Period is the date on which the parties described in requirement (2) of section 3.01 of this notice:

(1) obtain all new or additional permits or licenses (and any potential administrative appeals or potential judicial review by the applicable federal or state courts are finally resolved) described in section 3.01(5) of this notice;

(2) obtain written confirmation that the new or additional permits or licenses described in section 3.01(5) of this notice to be completed will not be issued; or

(3) notify the relevant federal or state regulatory, permitting, and/or licensing authorities in writing that the modification of the Plan will no longer be pursued.

In no event shall the Tolling Period exceed a period of four years.

.03 *Example*. X has an ownership interest in a facility. In September 2016, X begins construction of the facility. As part of a Plan to connect the facility to the energy grid, a new transmission line must be constructed. Y will develop, own, and operate the new transmission line. The route for the proposed transmission line runs adjacent to a DOD facility. In June 2018, Y receives all permits necessary for constructing the transmission line, although during the permitting process the DOD raised concerns with permitting authorities regarding the location of the proposed transmission line. Y identifies an alternative route for the transmission line and proposes to build the transmission line over this alternative route rather than over the original route. On December 1, 2018, Y receives a written notice from the DOD stating that the Plan raises significant concerns related to national security and that the proposed alternative route for the transmission line would be in the best interests of national security objectives. Constructing the transmission line along this alternative route requires that certain new permits and licenses be granted by various federal and state permitting and licensing agencies. On June 30, 2021, after any potential administrative appeals or potential judicial review of the permitting and licensing process have been resolved, Y obtains from the relevant federal and state agencies the new permits and licenses required to allow the transmission line to be completed.

The Tolling Period is calculated to run from December 1, 2018, through June 30, 2021 (943 days). The Continuity Safe Harbor will resume on July 1, 2021 and will be satisfied if the facility is placed in service by August 1, 2023 (943 days after December 31, 2020, which would have been the placed in service deadline under the Continuity Safe Harbor had it not been tolled and extended).

SECTION 4. EFFECT ON OTHER DOCUMENTS

Notice 2013-29, Notice 2013-60, Notice 2014-46, Notice 2015-25, Notice 2016-31, Notice 2017-04, and Notice 2018-59 are modified.

SECTION 5. NO RULE

The Internal Revenue Service will not issue private letter rulings or determination letters to a taxpayer regarding the application of this notice, the prior IRS notices, or the beginning of construction requirement under §§ 45 and 48.

SECTION 6. DRAFTING INFORMATION

The principal author of this notice is Jennifer Bernardini of the Office of Associate Chief Counsel (Passthroughs & Special Industries). For further information regarding this Notice, contact Ms. Bernardini at (202) 317-6853 (not a toll-free number).

Update for Weighted Average Interest Rates, Yield Curves, and Segment Rates

Notice 2019-44

This notice provides guidance on the corporate bond monthly yield curve, the corresponding spot segment rates used under § 417(e)(3), and the 24-month average segment rates under § 430(h)(2) of the Internal Revenue Code. In addition, this notice provides guidance as to the interest rate on 30-year Treasury securities under § 417(e)(3)(A)(ii)(II) as in effect for plan years beginning before 2008 and the 30-year Treasury weighted average rate under § 431(c)(6)(E)(ii)(I).

YIELD CURVE AND SEGMENT RATES

Section 430 specifies the minimum funding requirements that apply to single-employer plans (except for CSEC plans under § 414(y)) pursuant to § 412. Section 430(h)(2) specifies the interest rates that must be used to determine a plan's target normal cost and funding target. Under this provision, present value is generally determined using three 24-month average interest rates ("segment rates"), each of which applies to cash flows during specified periods. To the extent provided under § 430(h)(2)(C)(iv), these segment rates are adjusted by the applicable percentage of the 25-year average segment rates for the period ending September 30 of the year preceding the calendar year in which the plan year begins.[1] However, an election may be made under § 430(h)(2)(D)(ii) to use the monthly yield curve in place of the segment rates.

Notice 2007-81, 2007-44 I.R.B. 899, provides guidelines for determining the monthly corporate bond yield curve, and the 24-month average corporate bond segment rates used to compute the target normal cost and the funding target. Consistent with the methodology specified in Notice 2007-81, the monthly corporate bond yield curve derived from June 2019 data is in Table 2019-6 at the end of this notice. The spot first, second, and third segment rates for the month of June 2019 are, respectively, 2.41, 3.51, and 4.16.

The 24-month average segment rates determined under § 430(h)(2)(C)(i) through (iii) must be adjusted pursuant to § 430(h)(2)(C)(iv) to be within the applicable minimum and maximum percentages of the corresponding 25-year average segment rates. For plan years beginning before 2021, the applicable minimum percentage is 90% and the applicable maximum percentage is 110%. The 25-year average segment rates for plan years beginning in 2018 and 2019 were published in Notice 2017-50, 2017-41 I.R.B. 280, and Notice 2018-73, 2018-40 I.R.B. 526, respectively.

24-MONTH AVERAGE CORPORATE BOND SEGMENT RATES

The three 24-month average corporate bond segment rates applicable for July 2019 without adjustment for the 25-year average segment rate limits are as follows:

24-Month Average Segment Rates Without 25-Year Average Adjustment

Applicable Month	**First Segment**	**Second Segment**	**Third Segment**
July 2019	2.76	3.95	4.43

Based on § 430(h)(2)(C)(iv), the 24-month averages applicable for July 2019, adjusted to be within the applicable minimum and maximum percentages of the corresponding 25-year average segment rates, are as follows:

Adjusted 24-Month Average Segment Rates

For Plan Years Beginning In	**Applicable Month**	**First Segment**	**Second Segment**	**Third Segment**
2018	July 2019	3.92	5.52	6.29
2019	July 2019	3.74	5.35	6.11

30-YEAR TREASURY SECURITIES INTEREST RATES

Section 431 specifies the minimum funding requirements that apply to multiemployer plans pursuant to § 412. Section 431(c)(6)(B) specifies a minimum amount for the full-funding limitation described in § 431(c)(6)(A), based on the plan's current liability. Section 431(c)(6)(E)(ii)(I) provides that the interest rate used to calculate current liability for this purpose must be no more than 5 percent above and no more than 10 percent below the weighted average of the rates of interest on 30-year Treasury securities during the four-year period ending on the last day before the beginning of the plan year. Notice 88-73, 1988-2 C.B. 383, provides guidelines for determining the weighted average interest rate. The rate of interest on 30-year Treasury securities for June 2019 is 2.57 percent. The Service determined this rate as the average of the daily determinations of yield on the 30-year Treasury bond maturing in May 2049. For plan years beginning in July 2019, the weighted average of the rates of interest on 30-year Treasury securities and the permissible range of rates used to calculate current liability are as follows:

Treasury Weighted Average Rates

For Plan Years Beginning In	**30-Year Treasury Weighted Average**	**Permissible Range 90% to 105%**
July 2019	2.93	2.63 to 3.07

[1] Pursuant to § 433(h)(3)(A), the 3rd segment rate determined under § 430(h)(2)(C) is used to determine the current liability of a CSEC plan (which is used to calculate the minimum amount of the full funding limitation under § 433(c)(7)(C)).

MINIMUM PRESENT VALUE SEGMENT RATES

In general, the applicable interest rates under § 417(e)(3)(D) are segment rates computed without regard to a 24-month average. Notice 2007-81 provides guidelines for determining the minimum present value segment rates. Pursuant to that notice, the minimum present value segment rates determined for June 2019 are as follows:

Minimum Present Value Segment Rates

Month	**First Segment**	**Second Segment**	**Third Segment**
June 2019	2.41	3.51	4.16

DRAFTING INFORMATION

The principal author of this notice is Tom Morgan of the Office of the Associate Chief Counsel (Employee Benefits, Exempt Organizations, and Employment Taxes). However, other personnel from the IRS participated in the development of this guidance. For further information regarding this notice, contact Mr. Morgan at 202-317-6700 or Paul Stern at 202-317-8702 (not toll-free numbers).

Table 2019-6
Monthly Yield Curve for June 2019
Derived from June 2019 Data

Maturity	*Yield*	*Maturity*	*Yield*	*Maturity*	*Yield*	*Maturity*	*Yield*	*Maturity*	*Yield*
0.5	2.38	20.5	3.98	40.5	4.18	60.5	4.26	80.5	4.29
1.0	2.37	21.0	3.99	41.0	4.19	61.0	4.26	81.0	4.29
1.5	2.37	21.5	4.00	41.5	4.19	61.5	4.26	81.5	4.29
2.0	2.36	22.0	4.01	42.0	4.19	62.0	4.26	82.0	4.30
2.5	2.37	22.5	4.02	42.5	4.19	62.5	4.26	82.5	4.30
3.0	2.38	23.0	4.02	43.0	4.20	63.0	4.26	83.0	4.30
3.5	2.40	23.5	4.03	43.5	4.20	63.5	4.26	83.5	4.30
4.0	2.44	24.0	4.04	44.0	4.20	64.0	4.26	84.0	4.30
4.5	2.49	24.5	4.04	44.5	4.20	64.5	4.27	84.5	4.30
5.0	2.55	25.0	4.05	45.0	4.21	65.0	4.27	85.0	4.30
5.5	2.62	25.5	4.06	45.5	4.21	65.5	4.27	85.5	4.30
6.0	2.69	26.0	4.06	46.0	4.21	66.0	4.27	86.0	4.30
6.5	2.78	26.5	4.07	46.5	4.21	66.5	4.27	86.5	4.30
7.0	2.86	27.0	4.07	47.0	4.21	67.0	4.27	87.0	4.30
7.5	2.95	27.5	4.08	47.5	4.22	67.5	4.27	87.5	4.30
8.0	3.04	28.0	4.09	48.0	4.22	68.0	4.27	88.0	4.30
8.5	3.12	28.5	4.09	48.5	4.22	68.5	4.27	88.5	4.30
9.0	3.20	29.0	4.10	49.0	4.22	69.0	4.27	89.0	4.30
9.5	3.28	29.5	4.10	49.5	4.22	69.5	4.28	89.5	4.30
10.0	3.35	30.0	4.11	50.0	4.23	70.0	4.28	90.0	4.30
10.5	3.42	30.5	4.11	50.5	4.23	70.5	4.28	90.5	4.31
11.0	3.48	31.0	4.12	51.0	4.23	71.0	4.28	91.0	4.31
11.5	3.54	31.5	4.12	51.5	4.23	71.5	4.28	91.5	4.31
12.0	3.59	32.0	4.13	52.0	4.23	72.0	4.28	92.0	4.31
12.5	3.64	32.5	4.13	52.5	4.23	72.5	4.28	92.5	4.31
13.0	3.68	33.0	4.13	53.0	4.24	73.0	4.28	93.0	4.31
13.5	3.72	33.5	4.14	53.5	4.24	73.5	4.28	93.5	4.31
14.0	3.75	34.0	4.14	54.0	4.24	74.0	4.28	94.0	4.31
14.5	3.78	34.5	4.15	54.5	4.24	74.5	4.28	94.5	4.31
15.0	3.81	35.0	4.15	55.0	4.24	75.0	4.29	95.0	4.31
15.5	3.83	35.5	4.15	55.5	4.24	75.5	4.29	95.5	4.31
16.0	3.86	36.0	4.16	56.0	4.24	76.0	4.29	96.0	4.31
16.5	3.88	36.5	4.16	56.5	4.25	76.5	4.29	96.5	4.31
17.0	3.89	37.0	4.16	57.0	4.25	77.0	4.29	97.0	4.31
17.5	3.91	37.5	4.17	57.5	4.25	77.5	4.29	97.5	4.31
18.0	3.92	38.0	4.17	58.0	4.25	78.0	4.29	98.0	4.31
18.5	3.94	38.5	4.17	58.5	4.25	78.5	4.29	98.5	4.31
19.0	3.95	39.0	4.18	59.0	4.25	79.0	4.29	99.0	4.31
19.5	3.96	39.5	4.18	59.5	4.25	79.5	4.29	99.5	4.31
20.0	3.97	40.0	4.18	60.0	4.26	80.0	4.29	100.0	4.31

Part IV.

Withdrawal of Notice of Proposed Rulemaking; Notice of Proposed Rulemaking

Guidance on Passive Foreign Investment Companies

REG-105474-18

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Withdrawal of notice of proposed rulemaking; notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations under sections 1291, 1297, and 1298 of the Internal Revenue Code ("Code") regarding the determination of ownership in a passive foreign investment company within the meaning of section 1297(a) ("PFIC") and the treatment of certain income received or accrued by a foreign corporation and assets held by a foreign corporation for purposes of section 1297. The regulations provide guidance regarding when a foreign corporation is a qualifying insurance corporation ("QIC") under section 1297(f) of the Code and the amounts of income and assets that a QIC excludes from passive income and assets pursuant to section 1297(b)(2)(B) ("PFIC insurance exception") for purposes of section 1297(a). The regulations also clarify the application and scope of certain rules that determine whether a United States person that directly or indirectly holds stock in a PFIC is treated as a shareholder of the PFIC, and whether a foreign corporation is a PFIC. The regulations affect United States persons with direct or indirect ownership interests in certain foreign corporations.

DATES: Written or electronic comments and requests for a public hearing must be received by September 9, 2019.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG-105474-18), room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG-105474-18), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC 20224, or sent electronically via the Federal eRulemaking Portal at www.regulations.gov (IRS REG-105474-18).

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Josephine Firehock at (202) 317-4932 (for the PFIC Insurance Exception) or Jorge M. Oben at (202) 317-6934 (for general rules, including indirect ownership and look-through rules); concerning submissions and requests for a public hearing, Regina L. Johnson at (202) 317-6901 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

I. *In General*

This document contains proposed amendments to 26 CFR part 1 under sections 1291, 1297, and 1298. Sections 1291 through 1298 set forth tax regimes for shareholders that own stock of a PFIC. Under section 1297(a), a foreign corporation ("Tested Foreign Corporation") qualifies as a PFIC if it satisfies either of the following tests: (i) 75 percent or more of the Tested Foreign Corporation's gross income for a taxable year is passive ("Income Test"); or (ii) the average percentage of assets held by the Tested Foreign Corporation during a taxable year that produce (or that are held for the production of) passive income is at least 50 percent ("Asset Test"). Section 1297(b)(1) generally defines passive income as any income of a kind that would constitute foreign personal holding company income ("FPHCI") under section 954(c), and section 1297(b)(2) provides exceptions to this general definition. Income of a kind not described in section 954(c)(1) (for example, premiums on insurance and annuity contracts) is excluded from passive income.

In addition, section 1297(c) provides a look-through rule that applies when determining the PFIC status of a Tested Foreign Corporation that directly or indirectly owns at least 25 percent of the stock (determined by value) of another corporation.

Section 1298(b)(3) provides an exception from PFIC status for certain Tested Foreign Corporations that change from one active business to another active business. Section 1298(b)(7) provides that certain stock ("qualified stock") in a domestic C corporation owned by a Tested Foreign Corporation through a 25-percent-owned domestic corporation is treated as an asset generating non-passive income for purposes of section 1297(a), provided that the Tested Foreign Corporation is subject to the accumulated earnings tax or waives any treaty protections against the imposition of the accumulated earnings tax.

Section 1298(a) sets forth special rules applicable to shareholders of PFICs, including attribution rules that treat a United States person as the owner of PFIC stock that is owned by another person (other than an individual). For instance, section 1298(a)(2) sets forth the attribution rules for ownership through a corporation, and section 1298(a)(3) sets forth the attribution rules for ownership through a partnership, estate, or trust. In addition, section 1298(a)(1)(B) provides that, except to the extent provided in regulations, section 1298(a) will not apply to treat stock owned (or treated as owned) by a United States person as owned by another United States person.

The Department of the Treasury ("Treasury Department") and the IRS announced their intention to issue regulations that address the operation of the Income Test and Asset Test in Notice 88-22, 1988-1 C.B. 489 ("Notice 88-22").

II. *PFIC Insurance Exception*

Before its amendment by section 14501 of the Tax Cuts and Jobs Act, Pub. L. 115-97, 131 Stat. 2234 (2017) (the "Act"), former section 1297(b)(2)(B) provided that passive income generally did not include investment income derived in the active conduct of an insurance business by a corporation that is predominantly engaged in an insurance business and that would be subject to tax under subchapter L if it were a domestic corporation. Congress was concerned about a lack of clarity and precision in the PFIC insurance exception, and in particular about the lack of precision regarding how much insurance or reinsurance business a company must do to qualify under the exception, which made the exception difficult to enforce. H.R. Report 115-409 at 409-410. To address these concerns, the Act modified the PFIC insurance exception to provide that passive income does not include investment income derived in the active conduct of an insurance business by a QIC. Thus, for taxable years beginning after December 31, 2017, the PFIC insurance exception provides that a foreign corporation's income attributable to an insurance business will not be passive income if three requirements are met. First, the foreign corporation must be a QIC as defined in section 1297(f). Second, the foreign corporation must be engaged in an "insurance business." Third, the income must be derived from the "active conduct" of that insurance business.

On April 24, 2015, the **Federal Register** published a notice of proposed rulemaking at 80 FR 22954 (the "2015 proposed regulations") under former sections 1297(b)(2)(B) and 1298(g). The 2015 proposed regulations addressed the PFIC insurance exception and provided guidance regarding the extent to which a foreign corporation's investment income and the assets producing that income are excluded from passive income and passive assets for purposes of the passive income and passive asset tests in section 1297(a). Comments were received on the previously proposed regulations. A public hearing was requested and was held on September 18, 2015.

This document withdraws the 2015 proposed regulations and proposes new regulations with respect to the insurance exception as amended by the Act. Accordingly, this preamble does not address the comments received regarding the 2015 proposed regulations unless the comment relates to these new proposed regulations.

Explanation of Provisions

I. *General Rules*

A. *Overview*

These regulations provide guidance with respect to a number of issues that are not specifically addressed in the current regulations and resolve some of the complexities that arise in the determination of the ownership of a PFIC and in the application of the Income Test and Asset Test in cases in which the look-through rule of section 1297(c) applies to a Tested Foreign Corporation.

Specifically, these regulations provide guidance on the application of the corporate attribution rules when a partnership indirectly holds a Tested Foreign Corporation through a corporation that is not a PFIC. These regulations also clarify the scope of the section 1297(b)(1) cross-reference to section 954(c) for purposes of defining passive income, and they set forth rules that address certain computational and characterization issues that arise in applying the Asset Test. In addition, these regulations provide rules concerning the treatment of income and assets of a 25-percent-owned subsidiary under section 1297(c). These regulations provide guidance on the application of the section 1298(b)(3) change of business exception and also propose a new rule analogous to the section 1298(b)(3) change of business exception that takes into consideration the assets of the Tested Foreign Corporation. Finally, these regulations provide guidance on the application of the section 1298(b)(7) qualified stock exception and provide a rule for waiving treaty benefits that would exempt a Tested Foreign Corporation from the accumulated earnings tax.

B. *Determination of ownership and attribution through partnerships*

Section 1298(a) provides attribution rules that apply to the extent that the effect is to treat stock of a PFIC as owned by a United States person. Except as provided in regulations, the attribution rules do not apply to treat stock owned or treated as owned by a United States person as owned by any other person.

Section 1298(a)(2)(A) provides that if 50 percent or more in value of the stock of a corporation is owned, directly or indirectly, by or for any person, that person is considered to own the stock owned directly or indirectly by or for the corporation in proportion to the person's ownership of the corporation. However, under section 1298(a)(2)(B), the 50 percent ownership threshold does not apply in the case of stock held through a PFIC or a corporation that would be a PFIC if it were not a controlled foreign corporation within the meaning of section 957(a) ("CFC"). Section 1298(a)(3) provides that stock owned, directly or indirectly, by a partnership, estate, or trust is considered owned proportionately by its partners or beneficiaries. The current rules in §1.1291-1(b)(8) are consistent with these statutory provisions.

Comments have inquired whether the attribution rules are intended to be applied to a tiered ownership structure on a "top-down" basis, by starting with a United States person and determining what stock is considered owned at each successive lower tier on a proportionate basis. Alternatively, the comments have posited, the rules could be applied on a "bottom-up" basis, by starting with a PFIC and attributing ownership of its stock upwards to each successive upper tier until the United States person whose ownership in the PFIC is being tested is reached.

The two approaches can have different ownership consequences when a partnership indirectly owns stock of a Tested Foreign Corporation through a corporation that is not a PFIC. A United States person not treated as a shareholder of PFIC stock indirectly held by a partnership through a non-PFIC corporation under a "top-down" approach may be treated as a shareholder under a "bottom-up" approach as a result of the application of section 1298(a)(3) and §1.1291-1(b)(8)(iii), which provide that holders of interests in a pass-through entity are considered to proportionately own stock owned directly or indirectly by the pass-through entity. Consider, for example, the following fact pattern. A, a United States citizen, owns 50 percent of the interests in Foreign Partnership, a foreign partnership, the remainder of which is owned by an unrelated foreign person. Foreign Partnership owns 100 percent of the stock of FC1 and 50 percent of the stock of FC2, the remainder of which is owned by an unrelated foreign person. Both FC1 and FC2 are foreign corporations that are not PFICs (determined without applying section 1297(d)). FC1 and FC2 each own 50 percent of the stock of FC3, a foreign corporation that is a PFIC. Under a "bottom-up" approach, Foreign Partnership could be treated as owning 75 percent of the stock of FC3 indirectly through FC1 and FC2, and accordingly, A could be treated as owning 37.5 percent of the stock of FC3. Under a "top-down" approach, however, A would be treated as owning 50 percent of the stock of FC1 and 25 percent of the stock of FC2, and the only stock of FC3 that would be attributed to A would be the 25 percent of the FC3 stock treated as indirectly owned by A through FC1. Comments have noted that a "top-down" approach produces the same result as if the partnership were disregarded and partners were treated as if they directly or indirectly owned a partnership's direct and indirect interests in a non-PFIC foreign corporation; it could thus be viewed as consistent with an aggregate theory of partnerships.

Under the proposed regulations, the attribution rules apply consistently whether a United States person owns stock of a non-PFIC foreign corporation through a partnership or directly, as they would under the "top-down" approach. This ensures that ownership of a foreign corporation that is a PFIC through a partnership will not change the amount of the stock of the PFIC that the United States person is treated as owning. Accordingly, under the proposed regulations, for purposes of determining whether a partner, S corporation shareholder, or beneficiary in a partnership, S corporation, estate, or nongrantor trust is considered under §1.1291-1(b)(8)(ii)(A) to own a portion of stock of a PFIC owned indirectly by the partnership, S corporation, estate, or trust through a non-PFIC foreign corporation, the partner, shareholder, or beneficiary will be considered to own 50 percent or more in value of the stock of the non-PFIC foreign corporation through the partnership, estate, or trust only if the partner, shareholder, or beneficiary directly or indirectly owns 50 percent or more of the ownership interests in the partnership, estate, or trust. *See* proposed §1.1291-1(b)(8)(iii).

If, in the previously posited example, Foreign Partnership were replaced with another foreign corporation, FC4, the proposed regulations would not apply. It may seem less appropriate for the amount of FC3 stock that is treated as owned by A to be limited to the 25 percent of FC3 indirectly owned by A through FC4 and FC1. Instead, FC4 could be treated as owning 25 percent of the stock of FC3 indirectly through FC2, and thus A could be treated as owning 12.5 percent of the stock of FC3 indirectly through FC4 and FC2 in addition to the 25 percent owned indirectly through FC4 and FC1. The Treasury Department and the IRS request comments as to whether a "top-down" attribution analysis or some alternative analysis should apply under section 1298(a) in a purely corporate structure such as this one, such that A would not be treated as owning any stock of FC3 indirectly through FC4 and FC2.

C. *Income test*

1. In General

In the Technical and Miscellaneous Revenue Act of 1988 (Pub. L. 100-647, 102 Stat. 3342), Congress amended section 1297(b)(1) to define the term passive income generally as any income of a kind that would constitute FPHCI under section 954(c). FPHCI, and thus passive income, includes interest income that would be tax-exempt under section 103. *See* §§1.954-2(b)(3), 1.952-2(c)(1). Neither the rules under subtitle A, chapter 1, subchapter N, part III, subpart F of the Code ("subpart F") nor rules under section 1297, however, address the treatment for purposes of FPHCI or the Income Test of other types of income that are otherwise excluded from gross income, such as intercompany dividends that are excluded from the income of a recipient under the consolidated return regulations. *See* §1.1502-13(f)(2)(ii). As discussed in more detail in Part I.F of this Explanation of Provisions, a Tested Foreign Corporation may be treated under section 1297(c) as receiving directly income received by a 25-percent-owned subsidiary, including a domestic corporation. As discussed in more detail in Part I.H of this Explanation of Provisions, a Tested Foreign Corporation could own a second domestic corporation through a 25-percent-owned domestic corporate subsidiary and could thus be treated under sections 1297(c) and 1298(b)(7) as receiving intercompany dividends from the lower-tier domestic corporation that would be excluded from the income of the upper-tier domestic corporation under the consolidated return regulations. Accordingly, the operation of the statutory rules under sections 1297 and 1298 indicate that the Income Test is intended to take into account all income of a Tested Foreign Corporation, without regard to reductions or exclusions that might apply for purposes of determining the U.S. Federal income tax imposed on such income. Consistent with those rules, the Treasury Department and the IRS have concluded that intercompany dividends received by a corporation from a member of its consolidated group and treated as received under section 1297(c) by a Tested Foreign Corporation that directly or indirectly owns stock in the corporation should be taken into account for purposes of the Income Test. Thus, the proposed regulations indicate that income for purposes of the Income Test includes all dividend income, including dividends that are excluded from gross income under section 1502 and §1.1502-13. *See* proposed §1.1297-1(b). The Treasury Department and the IRS welcome comments on this approach. However, see Part I.F.3 of this Explanation of Provisions for a discussion of rules that could eliminate such dividends.

2. Exceptions from Passive Income

Furthermore, there are a number of exceptions to the definition of FPHCI in section 954(c), as well as in section 954(h) and (i), and special rules and definitions in section 954(c) that affect the determination of FPHCI. Specifically, in addition to the exceptions contained within the general definition of FPHCI in section 954(c)(1), section 954(c)(2) provides three exceptions: (i) an active rents and royalties exception; (ii) an export financing exception; and (iii) a dealer exception. Section 954(c)(3) provides two additional exceptions: (i) a related person, same country dividend and interest exception; and (ii) a related person, same country rents and royalty exception. In addition, for taxable years of foreign corporations beginning after December 31, 2005, and before January 1, 2020, section 954(c)(6) excludes from FPHCI certain dividends, interest, rents, and royalties received or accrued from a related corporation that is a CFC. Moreover, section 954(h) provides rules that apply for purposes of section 954(c)(1) pursuant to which income derived in an active banking or financing business is excluded from FPHCI. Additionally, under section 954(i), income from an active insurance business is excluded from FPHCI for purposes of section 954(c)(1). Finally, section 954(c)(4) contains a look-through rule that applies in the case of a sale of certain partnership interests, and section 954(c)(5) contains definitions and special rules applicable to commodity transactions.

Separately, section 1297(b)(2) provides explicit exclusions to the general definition of passive income set forth in section 1297(b)(1). Specifically, section 1297(b)(2) provides four exceptions: (i) an active banking exception; (ii) an active insurance business exception; (iii) a related person interest, dividends, rents, and royalties exception; and (iv) an export trade financing exception.

Questions have been raised regarding the scope of the cross-reference to section 954(c) in section 1297(b)(1) for purposes of defining passive income for PFIC purposes. Comments have inquired whether the section 954(c) reference in section 1297(b) incorporates all of the exceptions to FPHCI that are in section 954(c). In addition, by their terms, certain exceptions to FPHCI apply only to a foreign corporation that is a CFC. If these exceptions apply for PFIC purposes, the comments also question whether a Tested Foreign Corporation must also be a CFC in order to benefit from the exceptions.

The Treasury Department and the IRS understand that Congress did not intend for all of the exceptions in section 954(c) to apply for purposes of determining passive income under the PFIC provisions. In particular, the exceptions in section 954(c)(3) (relating to certain income received from related persons) and 954(c)(6) (relating to certain income received from related CFCs) were not meant to be taken into account for PFIC purposes. The legislative history indicates that Congress intended for the section 1297(c) look-through rules or the section 1297(b)(2)(C) exception to apply to income items that otherwise would be entitled to the section 954(c)(3) exception. It indicates:

The bill conforms the PFIC definition of passive income to the definition of passive income under subpart F (sec. 954(c)). This change, in conjunction with the look-through rule for certain 25-percent-owned corporations and the lookthrough rules added by the bill (described below), makes it explicit that earnings of certain related foreign corporations organized in the same country as its shareholder that, if distributed to the shareholder would be excluded from foreign personal holding company income under the same-country exception of subpart F (sec. 954(c)(3)), are subject to either the section [1297(c)] look-through treatment or the look-through treatment for amounts paid by related parties that are not 25 percent owned (described below).

H.R. Rep. No. 100-795, at 271-272 (1988); S. Rep. No. 100-445, at 285-286 (1988).

Thus, the proposed regulations do not incorporate the section 954(c)(3) exception for purposes of determining passive income for PFIC purposes. Similarly, under the proposed regulations, the section 954(c)(6) exception also does not apply for determining PFIC status because the section 1297(b)(2)(C) related-person exception is intended to be the sole related-person exception applicable for determining passive income under the PFIC rules.

Additional questions are raised with respect to the FPHCI exceptions for active banking, financing, and insurance income because section 1297(b) does not specifically cross-reference section 954(h) and (i). As with section 1297(b)(2)(C), it is possible that sections 1297(b)(2)(A) and (B) were intended to be the sole exceptions for active banking, financing, and insurance income applicable for determining passive income under the PFIC rules because section 1297(b) has specific exceptions for active banking, financing, and insurance income. Alternatively, the section 1297(b) cross-reference to section 954(c) could be read to include the exceptions provided in section 954(h) and (i), which apply for purposes of section 954(c) by their terms. It may be appropriate for income that satisfies the requirements in section 954(h) and (i) to be excluded from passive income because Congress generally defined passive income by reference to FPHCI, and when section 954(h) and (i) were enacted, each with a cross-reference to section 954(c), Congress did not provide that section 954(h) or (i) should not apply for PFIC purposes. Moreover, the fact that the PFIC provisions are more generally not intended to apply to foreign corporations engaged in active businesses supports the application of rules excluding active banking, financing, and insurance income from the definition of passive income.

However, with respect to section 954(i), Congress recently amended the exclusion for income derived in the active conduct of an insurance business in section 1297(b)(2)(B) to require that income be earned by a QIC, as discussed in Part II of the Background section of this preamble. Given this statutory change and the tests contained in the definition of QIC in section 1297(f), the Treasury Department and the IRS have determined that the exception for insurance income in section 954(i) should not apply in addition to the newly modified exception in section 1297(b)(2)(B). Accordingly, the proposed regulations provide that the section 954(i) exception to FPHCI does not apply in addition to the PFIC exception. *See* proposed §1.1297-1(c)(1)(i)(B). By contrast, given that no final regulations under the PFIC regime provide rules concerning an exclusion of active banking and financing income, these proposed regulations provide that the FPHCI exception for banking and financing income under section 954(h) applies for purposes of determining PFIC status. *See* proposed §1.1297-1(c)(1)(i)(A). The application of section 954(h) is in addition to the PFIC exception. The Treasury Department and the IRS request comments about whether, when regulations are in force under section 1297(b)(2)(A), the corollary FPHCI exclusion should also continue to apply.

Comments have noted that the application of section 954(c) for PFIC purposes can be uncertain when a Tested Foreign Corporation is not also a CFC. For instance, the application of section 954(h) for PFIC purposes could be interpreted to apply only to amounts received by a Tested Foreign Corporation that also is a CFC. Passive income for PFIC purposes is defined by cross-reference to section 954(c) because the income items that comprise FPHCI are generally passive in nature. The CFC status of the recipient of an item of FPHCI does not affect the passive nature of the item, and thus is not relevant for purposes of determining whether an item is passive under the PFIC rules. Therefore, it is appropriate for income derived by any Tested Foreign Corporation, and not just Tested Foreign Corporations that also are CFCs, to be eligible for the exceptions to FPHCI, including the section 954(h) exception.

For the reasons discussed in this Part I.C.2, the proposed regulations provide that for purposes of section 1297(b)(1), passive income is determined by reference to the items of income listed in section 954(c)(1), subject only to the exceptions found in section 954(c)(1), section 954(c)(2)(A) (relating to active rents and royalties), section 954(c)(2)(B) (relating to certain export financing interest), section 954(c)(2)(C) (relating to dealers), and section 954(h) (relating to entities engaged in the active conduct of a banking, financing, or similar business). *See* proposed §1.1297-1(c)(1)(i) and (c)(1)(i)(A). In addition, the rules in section 954(c)(4) (relating to sales of certain partnership interests) and 954(c)(5) (relating to certain commodity hedging transactions) apply for PFIC purposes. *See* proposed §1.1297-1(c)(1)(i)(C). However, for the reasons stated in this Part I.C.2, the exceptions in section 954(c)(3) (relating to certain income received from related persons), section 954(c)(6) (relating to certain amounts received from related controlled foreign corporations), and section 954(i) (relating to entities engaged in the active conduct of an insurance business) are not taken into account for purposes of section 1297(b)(1). *See* proposed §1.1297-1(c)(1)(i)(B). The proposed regulations also provide that an entity is treated as a CFC for purposes of applying an exception to FPHCI and for purposes of determining whether a person is a related person with respect to the entity. *See* proposed §1.1297-1(c)(1)(i)(D). Comments are requested as to whether regulations should provide any additional special rules concerning the definition of a related person under section 954(d)(3) for purposes of applying an FPHCI exception to a Tested Foreign Corporation that is not a CFC.

3. Income and Gains from Certain Transactions

The Income Test is computed based on a Tested Foreign Corporation's gross income. However, pursuant to section 954(c), certain categories of income are FPHCI only to the extent that gains exceed losses with respect to the category. For instance, under section 954(c)(1)(B) only "the excess of gains over losses from the sale or exchange" of certain property is treated as FPHCI. Similar rules apply to income from commodities transactions under section 954(c)(1)(C), foreign currency gains under section 954(c)(1)(D), and income from notional principal contracts under section 954(c)(1)(F). The proposed regulations provide that for purposes of the Income Test, items of income under section 954(c) that are determined by netting gains against losses are taken into account by a corporation on that net basis, so that only net gains in a particular category of FPHCI are taken into account. *See* proposed §1.1297-1(c)(1)(ii). However, the net amount of income in each category of FPHCI is determined separately for each relevant corporation, such that net gains or losses of a corporation, at least 25 percent of the value of stock of which is owned, directly or indirectly, by a Tested Foreign Corporation ("Look-Through Subsidiary") may not be netted against net losses or gains of another Look-Through Subsidiary or of a Tested Foreign Corporation.

4. Income Earned Through Partnerships

The proposed regulations provide guidance on the treatment of a corporation's distributive share of partnership income for purposes of the Income Test. The Treasury Department and the IRS have determined that income earned by a Tested Foreign Corporation through a partnership should be treated similarly to income earned through a corporate subsidiary. As discussed in more detail in Part I.F of this Explanation of Provisions, if a Tested Foreign Corporation owns a Look-Through Subsidiary, the Tested Foreign Corporation is treated as if it directly received its proportionate share of the income of the Look-Through Subsidiary, and certain items of income received from the Look-Through Subsidiary are proportionately eliminated. If a corporation is not a Look-Through Subsidiary, income received from the corporation is characterized in accordance with the general rules described in Part I.C.2 of this Explanation of Provisions, under which dividends generally will be passive. Accordingly, the proposed regulations provide that a Tested Foreign Corporation's distributive share of any item of income of a partnership is treated as income received directly by the Tested Foreign Corporation, provided the Tested Foreign Corporation owns, directly or indirectly, at least 25 percent of the value of the partnership, in which case the partnership is referred to as a "Look-Through Partnership," and income elimination rules similar to those for Look-Through Subsidiaries apply. *See* proposed §1.1297-1(c)(2)(i). If the Tested Foreign Corporation owns less than 25 percent of the value of a partnership, the corporation's distributive share of any item of income of the partnership is passive income. *See* proposed §1.1297-1(c)(2)(ii).

As a result of these rules, in cases in which the Tested Foreign Corporation owns at least 25 percent of the value of the partnership, the exceptions to passive income contained in section 1297(b)(2) and the relevant exceptions to foreign personal holding company income in section 954(c) and (h) that are based on whether income is derived in the active conduct of a business generally apply if, and only if, the partnership engages in the relevant business activities. The focus on partnership activities is consistent with the principles applicable to partnership interests under the regulations under subpart F. *See* §1.954-2(a)(5)(ii)(A); §1.954-3(a)(6). However, as described in Part I.F.5 of this Explanation of Provisions, these proposed regulations also include rules that, in certain circumstances, allow the character of income to be determined at the level of the Tested Foreign Corporation, taking into account activities performed by the Tested Foreign Corporation and certain subsidiaries of the Tested Foreign Corporation, whether such subsidiaries are in corporate or partnership form.

Although the subpart F regulations provide rules concerning the classification of a CFC's distributive share of partnership income that, absent these proposed regulations, would generally be applicable by virtue of section 1297's adoption of FPHCI as the basis for passive income, the Treasury Department and the IRS have determined that the differing policies of the subpart F and PFIC regimes warrant different rules for partnerships. Specifically, the Treasury Department and the IRS have concluded that it is appropriate to generally characterize a corporation's distributive share of partnership income as passive when the corporation owns less than 25 percent of the value of the partnership, consistent with the treatment of Look-Through Subsidiary income, notwithstanding the fact that under the subpart F regulations, such income could have been excluded from FPHCI by virtue of the partnership's activities regardless of the corporation's level of ownership. The different treatment is warranted because of the flexibility that entities have in their characterization for U.S. Federal income tax purposes under §301.7701-3 and because of the fact that treating a subsidiary as a partnership may not have U.S. income tax consequences for a Tested Foreign Corporation, as it could for a CFC. However, the Treasury Department and the IRS request comments as to whether a 25 percent threshold for the Tested Foreign Corporation's percentage ownership in the partnership is the appropriate threshold for distinguishing between a distributive share of partnership income that is automatically treated as passive and a distributive share that is characterized in accordance with the activities undertaken by the partnership (or, as applicable under the rules described in Part I.F.5 of this Explanation of Provisions, the Tested Foreign Corporation and certain subsidiaries of the Tested Foreign Corporation), or whether an alternative threshold should be considered. Furthermore, the Treasury Department and the IRS request comments as to whether different rules should apply with respect to partners in general partnerships than with respect to partners in limited partnerships, or with respect to partners that materially participate in the activities of the partnership.

5. Income from a Related Person

The proposed regulations provide additional guidance on the application of the section 1297(b)(2)(C) related-person exception to dividends, interest, rents, and royalties. The proposed regulations provide that the determination of whether the payor of an item of income is a related person should be made on the date of receipt or accrual, as applicable based on the recipient's method of accounting, of the item of income. *See* proposed §1.1297-1(c)(3)(iv).

Under §1.904-5(c)(2)(ii)(C) (the "cream-skimming rule"), interest paid to a related person is treated as passive income to the payee to the extent that the payor has passive income. Under this rule, if a foreign corporation had $200 of passive gross income and $200 of non-passive gross income, and that foreign corporation made an interest payment of $100 to a related foreign corporation, for purposes of determining the nature of the interest income in the hands of the payee foreign corporation, the entire $100 of interest would be treated as passive income rather than as ratably allocable between passive and non-passive income. Although the Treasury Department and the IRS considered applying a cream-skimming rule for purposes of section 1297(b)(2)(C), the Treasury Department and the IRS have concluded that the PFIC regime does not raise the policy concerns addressed by the cream-skimming rule in the foreign tax credit and subpart F contexts. In those contexts, because interest expense can reduce a foreign corporation's subpart F income or otherwise affect the calculation of foreign tax credits, an interest payment could otherwise be used to try to reduce the passive income of the payor and convert it into non-passive income of the payee. However, because the Income Test is applied on the basis of gross income, an interest payment cannot be used in the same fashion for purposes of the Income Test. Accordingly, under the proposed regulations, for purposes of the section 1297(b)(2)(C) exception, interest is properly allocable to income of the related person that is not passive income based on the relative portion of the related person's income for its taxable year that ends in or with the taxable year of the recipient that is not passive income. *See* proposed §1.1297-1(c)(3)(i). Dividends are treated as properly allocable to income of the related person that is not passive income based on the portion of the related payor's current-year earnings and profits for the taxable year that ends in or with the taxable year of the recipient that are attributable to non-passive income. *See* proposed §1.1297-1(c)(3)(ii). Comments are specifically requested concerning alternative methods of determining the portion of dividends treated as properly allocable to income of a related person (including if the payor has no current earnings and profits), including by reference to accumulated earnings and profits, and if so, how to address concerns about the availability of information. The proposed regulations further provide that rents and royalties are allocable to income of the related person which is not passive income to the extent the related person's deduction for the rent or royalty is allocated to non-passive income under the principles of §§1.861-8 through 1.861-14T. *See* proposed §1.1297-1(c)(3)(iii). Comments are specifically requested regarding any concerns about the availability of information and alternative methods of determining the portion of rents and royalties treated as properly allocable to income of a related person that would address any such concerns.

D. *Asset test*

1. Methodology of Application of Asset Test

Section 1297(a)(2) provides that a Tested Foreign Corporation is a PFIC if the average percentage of assets held by the corporation during a taxable year that produce passive income or are held for the production of passive income is at least 50 percent. Notice 88-22 provides that the average percentage of assets of a Tested Foreign Corporation is calculated by averaging the value of the assets of the corporation, determined as of the end of each quarterly period of the corporation's taxable year.

These regulations clarify that the average percentage of a Tested Foreign Corporation's assets is determined using the average of the gross values (or adjusted bases) at the end of each quarter of the foreign corporation's taxable year. *See* proposed §1.1297-1(d)(1)(i) and (d)(1)(ii)(A). Alternatively, the assets of a Tested Foreign Corporation can be measured for purposes of the Asset Test more frequently than quarterly (for example, weekly or monthly). The quarter or shorter interval used by a Tested Foreign Corporation is referred to as its "measuring period." Applying the Asset Test based on a period that recurs more frequently than a quarter provides a more precise measurement of "average," but the more frequently recurring basis is not required because of the potential administrative burden that it could impose on a shareholder of a Tested Foreign Corporation. The same measuring period must be used for the Tested Foreign Corporation for the initial year (including a short year) that for which the shareholder elects to use the alternative measuring period and any and all subsequent years unless the election to use the more frequently recurring measuring period is revoked. *See* proposed §1.1297-1(d)(1)(ii)(B).

If a Tested Foreign Corporation has a short taxable year, the quarterly measuring dates for purposes of the Asset Test are the same as they would be for a full taxable year, except that the final quarterly measuring date will be the final day of the short taxable year. *See* proposed §1.1297-1(d)(1)(ii)(C). Thus, for instance, if a Tested Foreign Corporation for which the election for a shorter period has not been made has a short year of eight months, the corporation would have two quarters ending on the foreign corporation's normal quarterly measuring dates and a third quarter ending on the final day of the short taxable year. The asset amounts for those three quarterly measuring dates would be averaged to determine the average percentage of a Tested Foreign Corporation's assets that are passive for the year. The Treasury Department and the IRS have determined that applying the Asset Test based on the taxable year quarters that ended during the short year properly accounts for the administrative difficulties of calculating quarterly measurements with respect to a short year.

Under section 1297(e), the assets of a Tested Foreign Corporation are required to be measured based on (i) value, pursuant to section 1297(e)(1), if it is a publicly traded corporation for the taxable year, or if section 1297(e)(2) does not apply to it for the taxable year; or (ii) adjusted basis, pursuant to section 1297(e)(2), if it is a CFC, or elects the application of section 1297(e)(2). The statute does not specify whether a corporation that is publicly traded during only part of the taxable year is publicly traded "for the taxable year," and thus whether such a corporation's assets should be measured for the taxable year based on value or on adjusted basis or whether, if the corporation is a CFC for the remainder of the year, a combination of the two should be used. For instance, a Tested Foreign Corporation that is a CFC at the beginning of its taxable year and became publicly traded during the last month of its taxable year could be required under section 1297(e) to have its assets measured based on either adjusted basis or value for all four quarterly measuring periods or based on adjusted basis for its first three quarterly measuring periods and value for its fourth quarterly measuring period. The proposed regulations provide that the Asset Test should apply on the basis of value for the entire year if the corporation was publicly traded on the majority of days during the year or section 1297(e)(2) did not apply to the corporation on the majority of days of the year. Otherwise, the Asset Test should apply on the basis of adjusted basis for the entire year. *See* proposed §1.1297-1(d)(1)(v). The Treasury Department and the IRS have determined that allowing a shareholder the option of choosing either method with respect to a Tested Foreign Corporation could facilitate the avoidance of the PFIC rules, and that the rule in the proposed regulation imposes the least administrative burden. The Treasury Department and the IRS welcome comments on these rules.

Under the proposed regulations, the rules described in this Part I.D.1 for making or revoking an election for an alternative measuring period also apply for purposes of the election provided in section 1297(e)(2)(B) to use adjusted bases of assets for purposes of the Asset Test. *See* proposed §1.1297-1(d)(1)(iii)(B) and (d)(1)(iv). Both elections may be made by a United States person that is eligible under §1.1295-1(d) with respect to the Tested Foreign Corporation or that would be eligible if the Tested Foreign Corporation were a PFIC. *See* proposed §1.1297-1(d)(1)(iv)(A). Thus, in the case of a Tested Foreign Corporation owned by a domestic partnership in which U.S. individuals are partners, only the domestic partnership and not its partners may make the elections, ensuring that the Tested Foreign Corporation is treated consistently for all of the partners, which would facilitate reporting by the partnership if the Tested Foreign Corporation were a PFIC. However, the Treasury Department and the IRS request comments as to whether either election should be available to any United States person that is a shareholder (within the meaning of §1.1291-1(b)(7) or (8)) of the Tested Foreign Corporation or that would be a shareholder of the Tested Foreign Corporation if it were a PFIC.

If the person is required to file the Form 8621 (or successor form) with respect to the Tested Foreign Corporation, the elections may be made in the manner provided in the instructions to the Form 8621; until such instructions are provided, the elections may be made by attaching a written statement to the Form 8621 providing for the election to a return for the year for which the election is made. If the person is not required to file the Form 8621 with respect to the Tested Foreign Corporation (for example, because the Tested Foreign Corporation is not a PFIC), the person may make the elections by attaching a written statement providing for the election to a return for the year for which the election is made. *Id.* The elections are revoked in a similar manner. *See* proposed §1.1297-1(d)(1)(iv)(B). A new election for an alternative measuring period or under section 1297(e)(2)(B) may not be made until the sixth taxable year following the year for which the previous such election was revoked, and such subsequent election may not be revoked until the sixth taxable year following the year for which the subsequent election was made. *See id.*

2. Characterization of Dual-Character Assets

Pursuant to section 1297(a), an asset is considered passive for purposes of the Asset Test if it produces passive income or is held for the production of passive income. Notice 88-22 states that an asset that produces both passive income and non-passive income during a Tested Foreign Corporation's taxable year is treated partly as a passive asset and partly as a non-passive asset in proportion to the relative amounts of income generated by the asset during the year. Proposed §1.1297-1(d)(2) generally adopts the rule set forth in Notice 88-22, and provides that an asset that produces both passive income and non-passive income during a taxable year is treated as two assets, one of which is passive and one of which is non-passive. Consistent with the rule in Notice 88-22, for purposes of applying the Asset Test, the value (or adjusted basis) of the asset is allocated between the passive assets and non-passive assets based on the ratio of passive income produced by the asset during the taxable year to non-passive income.

The proposed regulation also provides a specific rule for stock of a related person with respect to which no dividends are received or accrued, as applicable based on the recipient's method of accounting, during a taxable year but that previously generated dividends that were characterized as non-passive income, in whole or in part, under section 1297(b)(2)(C). *See* proposed §1.1297-1(d)(2)(iii). The stock is characterized based on the dividends received or accrued, as applicable based on the recipient's method of accounting, with respect thereto for the prior two years. *Id.*

The Treasury Department and the IRS have determined that it may also be appropriate to bifurcate an asset that in part produces income and in part does not produce income between a passive and a non-passive asset for purposes of the Asset Test in order to provide a more accurate measure of the Tested Foreign Corporation's passive assets. For example, if a Tested Foreign Corporation uses a portion of a building, which is depreciable real property, in its trade or business that generates non-passive income, while renting a portion of the building in exchange for rents that are treated as passive, it would be appropriate for the portions of the building to be considered separately as non-passive and passive assets, respectively. Accordingly, the proposed regulations provide that for purposes of applying the Asset Test, if an asset in part produces income and in part does not produce any income, the asset must be bifurcated pursuant to the method that most reasonably reflects the uses of the property. *See* proposed §1.1297-1(d)(2)(ii). A similar approach applies to characterize gain for subpart F purposes. *See* §1.954-2(e)(1)(iv).

The Treasury Department and the IRS welcome comments on these rules, including suggestions for how to minimize the burden associated with determining how to bifurcate the relevant assets.

3. Characterization of Partnership Interests

The proposed regulations provide guidance on the characterization of a partnership interest for purposes of the Asset Test. As discussed in Part I.C.4 of this Explanation of Provisions, the Treasury Department and the IRS have determined that it is appropriate to treat a partnership in a manner similar to a corporate subsidiary for purposes of determining whether a Tested Foreign Corporation is a PFIC. Accordingly, the proposed regulations provide that for purposes of the Asset Test, a Tested Foreign Corporation that directly or indirectly owns an interest in a partnership is treated as if it held its proportionate share of the assets of a partnership, provided the Tested Foreign Corporation owns, directly or indirectly, at least 25 percent, by value, of the interests in the partnership. *See* proposed §1.1297-1(d)(3)(i). A corporation's proportionate share of a partnership asset is treated as producing passive income, or being held to produce passive income, to the extent the asset produced, or was held to produce, passive income in the partnership's hands, taking into account only the partnership's activities, unless the rules described in Part I.F.5 of this Explanation of Provisions apply to allow the character of the income to be determined at the level of the Tested Foreign Corporation, taking into account activities performed by certain subsidiaries of the Tested Foreign Corporation. If a Tested Foreign corporation owns less than 25 percent of the value of the partnership, its interest in the partnership is treated as a passive asset. *See* proposed §1.1297-1(d)(3)(ii).

4. Characterization of Dealer Property

For purposes of the Asset Test, an asset is considered passive if it produces passive income or is held for the production of passive income. Under the dealer exception in section 954(c)(2)(C), gain from the disposition of certain dealer property is treated as non-passive income for purposes of the Income Test. However, certain other income derived with respect to the dealer property (such as dividends and interest) is treated as passive income. The exception from passive income for dealer property in section 954(c)(2)(C) is predicated on the fact that a dealer holds the property as part of its trade or business and not for the production of passive income. Accordingly, the Treasury Department and the IRS have determined that, given that the PFIC regime is concerned with whether the asset is part of an active business, it is appropriate to characterize dealer property for purposes of the Asset Test based solely on the character of the gain derived from the disposition of the property. Accordingly, the proposed regulations provide that property that is subject to the dealer exception is characterized as a non-passive asset for purposes of the Asset Test, notwithstanding the dual-character asset rules discussed in Part I.D.2 of this Explanation of Provisions. *See* proposed §1.1297-1(d)(4).

E. *Treatment of stapled entities*

The Treasury Department and the IRS understand that, in certain situations, equity interests in two or more foreign entities must be sold together as stapled interests within the meaning of section 269B(c)(3). Stapled entities (as defined in section 269B(c)(2)) may be structured in such a way that income and the assets generating the income are in one entity, while the activities generating the income are engaged in by the other entity. For example, two stapled entities might jointly carry on a real estate business, with one stapled entity owning real property that is leased to third parties to generate rental income, while the other stapled entity provides management services with respect to the real property that, if engaged in by the first stapled entity, would allow the rental income received by it to be characterized as non-passive income pursuant to section 954(c)(2)(A) and these proposed regulations. However, if the PFIC status of the stapled entity receiving the rental income were determined on a stand-alone basis, the income might be treated as passive income. Given that stapled interests represent a single economic interest to their shareholders, the Treasury Department and the IRS have determined that it is appropriate, for purposes of determining whether a stapled entity is a PFIC, to treat them as such. This is consistent with the treatment of stapled entities in section 269B(a)(3) for purposes of determining whether a stapled entity is a regulated investment company ("RIC") or a real estate investment trust ("REIT"). Accordingly, the proposed regulations provide that for purposes of determining whether any stapled entity is a PFIC, all entities that are stapled entities with respect to each other are treated as one entity. *See* proposed §1.1297-1(e). Comments are requested as to whether similar treatment should be provided for purposes of the subpart F rules.

F. *Look-through rule for 25-percent-owned subsidiaries*

As noted in Part I.C.4 of this Explanation of Provisions, in determining PFIC status, section 1297(c) applies when a Tested Foreign Corporation owns, directly or indirectly, at least 25 percent of the value of the stock of another corporation, a Look-Through Subsidiary. In such instance, the Tested Foreign Corporation is treated as if it directly held its proportionate share of the assets and directly received its proportionate share of the income of the Look-Through Subsidiary. Section 1297(c) was enacted to prevent "foreign corporations owning the stock of subsidiaries engaged in active businesses [from being] classified as PFICs." H.R. Rep. No. 99-841, at II-644 (1986) (Conf. Rep.).

1. Determining a Tested Foreign Corporation's Ownership of a Look-Through Subsidiary and Proportionate Share of a Look-Through Subsidiary's Assets and Income

Neither the statute nor the regulations provide guidance on how to calculate a Tested Foreign Corporation's indirect ownership in another corporation for purposes of determining whether the corporation is a Look-Through Subsidiary under section 1297(c). In addition, the statute and regulations do not provide a methodology for determining a Tested Foreign Corporation's proportionate share of a Look-Through Subsidiary's income and assets for purposes of section 1297(c).

Under section 1297(c), the determination of whether a Tested Foreign Corporation owns, directly or indirectly, at least 25 percent of the stock of another corporation is based on value. The proposed regulations provide that indirect stock ownership for purposes of section 1297(c) is determined under the principles of section 958(a) applicable for determining ownership by value. *See* proposed §1.1297-2(b)(1). The section 958(a) principles apply without regard to whether entities are domestic or foreign, and thus indirect ownership includes corporate ownership through intermediate corporations, partnerships, trusts, and estates, regardless of whether such intermediate entities are foreign or domestic. *Id.* In addition, stock considered owned by reason of applying the section 958(a) indirect ownership rules is generally considered actually owned for purposes of reapplying the indirect ownership rules. *See* §1.958-2(f)(1).

Section 1297(c) provides that a Tested Foreign Corporation is treated as holding its proportionate share of the assets of the Look-Through Subsidiary, and receiving its proportionate share of the income of the Look-Through Subsidiary. The proposed regulations provide guidance on the meaning of "proportionate share" for purposes of section 1297(c). Specifically, proposed §1.1297-2(b)(2) provides that a Tested Foreign Corporation is treated as owning a share of each asset, and receiving a proportionate share of each item of income, of a Look-Through Subsidiary proportionate to the Tested Foreign Corporation's percentage ownership (by value) of the Look-Through Subsidiary. Comments are requested concerning alternative methods that might better determine a Tested Foreign Corporation's proportionate share of income of a Look-Through Subsidiary that has multiple classes of stock outstanding.

Changes in stock ownership may cause fluctuations in a Tested Foreign Corporation's ownership in a Look-Through Subsidiary during a taxable year. For purposes of the Asset Test, ownership of a Look-Through Subsidiary is determined on each measuring date. *See* proposed §1.1297-2(b)(2)(i). If the requisite 25-percent ownership is not met with respect to a corporation on the last day of a measuring period, as defined in Part I.D.1 of this Explanation of Provisions, the stock of the corporation would be a passive asset for purposes of that measuring period, absent the application of a special rule, such as the new rule for dealer property in proposed §1.1297-1(d)(4), described in Part I.D.4 of this Explanation of Provisions. For purposes of the Income Test, a subsidiary is considered a Look-Through Subsidiary if the Tested Foreign Corporation owns an average of 25 percent of the value of the subsidiary for the year, taking into account its ownership on the last day of each measuring period of the Tested Foreign Corporation's taxable year. *See* proposed §1.1297-2(b)(2)(ii)(A). If the Tested Foreign Corporation does not maintain, on average, at least 25-percent ownership of the subsidiary for the taxable year, the Tested Foreign Corporation is not, under the general rule in the proposed regulations, treated as receiving its proportionate share of the income of the subsidiary for that year under section 1297(c). However, the Tested Foreign Corporation may be treated as receiving directly its proportionate share of the income of the subsidiary for each measuring period in a taxable year for which the 25-percent ownership requirement is met on the relevant measuring date, provided the taxpayer can establish gross income for each of those measuring periods. *See* proposed §1.1297-2(b)(2)(ii)(B). Comments are requested concerning appropriate methods for a taxpayer to establish gross income for a measuring period.

2. Overlap Between Section 1297(c) and Section 1298(b)(7)

Section 1298(b)(7) provides a special characterization rule that applies when a Tested Foreign Corporation owns at least 25 percent of the value of the stock of a domestic corporation and is subject to the accumulated earnings tax under section 531 (or waives any benefit under a treaty that would otherwise prevent imposition of such tax). In such instance, section 1298(b)(7) treats the qualified stock held by the domestic corporation as a non-passive asset, and the related income as non-passive income. By its terms, the section 1297(c) look-through rule also could apply to the qualified stock, which is stock in a domestic C corporation that is not a RIC or REIT, and look through to the assets of the corporation that issued the qualified stock for purposes of the Income Test and Asset Test. For example, assume a Tested Foreign Corporation owns 50 percent of the value of the stock in a domestic corporation, US1, which, in turn, owns 50 percent of the stock of a lower tier domestic corporation, US2 (which is not a RIC or a REIT). US2 wholly owns the stock of a foreign corporation, FC. The section 1297(c) look-through rule applies to treat the Tested Foreign Corporation as if it held its proportionate share of the assets, and received a proportionate share of the income, of US1. Both the section 1297(c) look-through rule and the section 1298(b)(7) characterization rule, by their terms, would apply to the stock of US2. The section 1297(c) rule would look through to the assets of US2 and FC. The section 1298(b)(7) characterization rule would treat the stock of US2 as a non-passive asset, and the income derived from the stock as income as non-passive income.

The Treasury Department and the IRS have determined that the special characterization rule of section 1298(b)(7) should generally take precedence over the section 1297(c) look-through rule when both rules would apply simultaneously because the characterization rule of section 1298(b)(7) is the more specific rule where the Tested Foreign Corporation owns a domestic corporation. Thus, the proposed regulations provide that the look-through rule of section 1297(c) does not apply to a domestic corporation, and any subsidiaries of the domestic corporation, if the stock of the domestic corporation is characterized, under section 1298(b)(7), as a non-passive asset producing non-passive income. *See* proposed §1.1297-2(b)(2)(iii). However, these proposed regulations provide certain limitations on the application of section 1298(b)(7), including a new anti-abuse rule, in which case section 1297(c) would apply. The limitations and anti-abuse rule are described in Part I.H of this Explanation of Provisions. The Treasury Department and the IRS welcome comments on these rules.

3. Elimination of Certain Assets and Income for Purposes of Applying Section 1297(a)

Section 1297(c) aggregates the income and assets of a Tested Foreign Corporation and a Look-Through Subsidiary for purposes of testing the PFIC status of the Tested Foreign Corporation. However, there are no statutory or regulatory rules that prevent the double counting of income and assets arising from contracts and other transactions among a Tested Foreign Corporation and one or more Look-Through Subsidiaries. Intercompany items that are not eliminated for purposes of determining a Tested Foreign Corporation's PFIC status may result in a duplication of passive income or passive assets attributed to the Tested Foreign Corporation. For instance, if a wholly-owned Look-Through Subsidiary earned $100x of passive income during a taxable year, and distributed the $100x as a dividend to a Tested Foreign Corporation, the Tested Foreign Corporation would have a total of $200x of passive income ($100x of passive income under section 1297(c) and a $100x dividend) for purposes of the Income Test, even though only $100 of passive income was earned economically. Any double-counting of intercompany income and assets distorts the effect of section 1297(c) on the Income Test and Asset Test.

The legislative history to the PFIC rules provides an approach that would eliminate certain assets and income in order to prevent double-counting. *See* H.R. Rep. No. 100-795, at 268 (1988) ("Under this look-through rule, a foreign corporation that owns at least 25 percent of the stock of another corporation is treated as owning a proportionate part of the other corporation's assets and income. Thus, amounts such as interest and dividends received from foreign or domestic subsidiaries are eliminated from the shareholder's income in applying the income test and the stock or debt investment is eliminated from the shareholder's assets in applying the asset test."); Staff, Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986, JCS-10-87, at 1026 (1987). The Treasury Department and the IRS have determined that it is appropriate to follow that approach. Thus, the proposed regulations provide that intercompany payments of dividends and interest between a Look-Through Subsidiary and the Tested Foreign Corporation and stock and debt receivables are eliminated in applying the Income Test and the Asset Test. *See* proposed §1.1297-2(c)(1) and (2). In the case of dividends, in order to qualify for elimination, the payment must be attributable to income of a Look-Through Subsidiary that was included in gross income by the Tested Foreign Corporation for purposes of determining its PFIC status. *See* proposed §1.1297-2(c)(2). Thus, dividends attributable to income of the Look-Through Subsidiary earned in a year before the Tested Foreign Corporation owned, on average, at least 25% by value of the Look-Through Subsidiary would generally not qualify for elimination. As a result of the elimination rule, for example, interest and dividends received by a Tested Foreign Corporation from a wholly owned Look-Through Subsidiary are eliminated from the Tested Foreign Corporation's gross income for purposes of applying section 1297(a)(1), except to the extent that dividend amounts are attributable to income that has not been treated as received directly by the Tested Foreign Corporation under the section 1297(c) look-through rule. Additionally, the proposed regulations extend this treatment to intercompany payments between two Look-Through Subsidiaries of a Tested Foreign Corporation and the associated stock and debt receivables. Similarly, stock and debt investments in a lower-tier Look-Through Subsidiary are eliminated for purposes of applying the Income Test and Asset Test to the Tested Foreign Corporation. In the case of a Tested Foreign Corporation that owns less than 100 percent of a Look-Through Subsidiary, the proposed regulations provide that while stock and dividends are eliminated in their entirety, eliminations of debt receivables and interest are made in proportion to the shareholder's direct and indirect ownership (by value) in the Look-Through Subsidiary. The proposed regulations also provide for eliminations under these principles for ownership interests in a Look-Through Partnership, as well as intercompany debt receivables and interest paid or accrued thereon between a Tested Foreign Corporation and a Look-Through Partnership. *See* proposed §1.1297-2(c)(3). Comments are requested on the application of the elimination rule if the Tested Foreign Corporation owns less than 100 percent of the Look-Through Subsidiary or Partnership. Comments are also requested as to whether the Treasury Department and the IRS should consider the elimination of rents, royalties, or any other types of intercompany income, and any related assets, and if so, how to effectuate the elimination.

4. Section 1297(b)(2)(C) Related Person Determination with Respect to Interest, Dividends, Rents, and Royalties Received by Look-Through Subsidiaries and Certain Partnerships

Section 1297(c) provides that a Tested Foreign Corporation is treated as receiving directly its proportionate share of the income of a Look-Through Subsidiary for purposes of applying the Income Test to the Tested Foreign Corporation. Section 1297(b)(2)(C) provides that, for purposes of the Income Test, passive income does not include interest, dividends, rents or royalties received or accrued from a related person (within the meaning of section 954(d)(3)) to the extent such amount is properly allocable to income of the related person that is not passive income. The statute and current regulations do not address the level at which the "related person" determination is made if a Look-Through Subsidiary receives or accrues an item of income that is treated as directly received by a Tested Foreign Corporation pursuant to section 1297(c). Thus, the interaction and application of the two rules is unclear in cases in which the payor of an item of income is a "related person" with respect to either the Look-Through Subsidiary or the Tested Foreign Corporation, but not with respect to both.

The Treasury Department and the IRS have determined that, because section 1297(c) generally applies by classifying an item at the level of Look-Through Subsidiary and then carrying that classification up to the Tested Foreign Corporation, it is appropriate to determine whether the section 1297(b)(2)(C) exception applies (and, thus, determine the passive or non-passive character of an item of income) at the Look-Through Subsidiary level, and then flow up the passive or non-passive character of the item to the Tested Foreign Corporation for purposes of applying the Income Test. Accordingly, proposed §1.1297-2(d)(1) provides that, in applying section 1297(b)(2)(C), "related person" status is tested with respect to the payor of the item of income and the Look-Through Subsidiary. The same rule applies for items of income received by a partnership and treated as received directly by a Tested Foreign Corporation pursuant to proposed §1.1297-1(c)(2). The Treasury Department and the IRS welcome comments on these rules.

5. Attribution of Activities of a Look-Through Subsidiary and Certain Partnerships

The interaction of section 1297(c) and certain exceptions from passive income also raises issues that require a threshold determination of whether an exception should apply at a Look-Through Subsidiary level or a Tested Foreign Corporation level. For instance, under proposed §1.1296-4 in the notice of proposed rulemaking (INTL-0065-93) published in the **Federal Register** (60 FR 20922) on April 28, 1995, the banking exception in section 1297(b)(2)(A) applies only if a number of requirements are satisfied, including a deposit taking requirement, a lending requirement, and a license requirement. *See* proposed §1.1296-4. In a bank holding company structure, in which a Tested Foreign Corporation wholly owns a Look-Through Subsidiary that separately satisfies the section 1297(b)(2)(A) requirements, the banking exception would apply to the income derived by the Look-Through Subsidiary in its banking business if an approach that applied the exception at the Look-Through Subsidiary level were adopted, but would not apply if an approach that applied the exception at the Tested Foreign Corporation level were adopted because the Tested Foreign Corporation would not literally meet all of the banking exception requirements. Similarly, the character of assets held by a Look-Through Subsidiary that is a dealer in property in the ordinary course of its trade or business as a dealer would depend on whether an approach that applied the exception in section 954(c)(2)(C) at the Look-Through Subsidiary level were adopted, or whether an approach were applied that determined the character at the level of a Tested Foreign Corporation that was not itself a dealer.

A corollary issue arises with respect to the application of other exceptions to passive income under section 954(c). For instance, under §1.954-2(c)(1)(ii), the active rental income exception in section 954(c)(2)(A) applies if certain activities are performed with respect to real property by the lessor's own employees. In a structure in which a Tested Foreign Corporation holds real estate assets directly and employees of its Look-Through Subsidiary conduct the activities related to the Tested Foreign Corporation's real estate business necessary to satisfy the exception, the exception would apply if the character of the income were determined at the level of the Tested Foreign Corporation and the activities of the managers and employees of the Look-Through Subsidiary were attributed to the Tested Foreign Corporation. However, the exception would not apply if the activities were not attributed to the Tested Foreign Corporation, because in such case the relevant activities are not performed by employees of the Tested Foreign Corporation, as literally required in the regulation. Additional complexities arise when the Tested Foreign Corporation owns less than 100 percent of the Look-Through Subsidiary.

Under current law, the character of income or assets is determined at the level of the entity that directly earns the income or holds the assets based on the activities of that entity. However, the Treasury Department and the IRS understand that active businesses in foreign jurisdictions generating rent and royalty income are often organized with assets and income, on the one hand, and activities, on the other hand, contained in separate entities for various business reasons. The Treasury Department and the IRS have determined that if assets are held and activities undertaken in separate entities within a group of wholly-owned Look-Through Subsidiaries headed by a Tested Foreign Corporation, the activities of the Look-Through Subsidiaries should be taken into account for purposes of determining whether an item of rent or royalty income of the Tested Foreign Corporation is passive income, as they would if the Look-Through

Subsidiaries were disregarded as separate from the Tested Foreign Corporation for U.S. Federal income tax purposes.

Accordingly, the proposed regulations provide that an item of rent or royalty income received or accrued by a Tested Foreign Corporation (or treated as received or accrued by the Tested Foreign Corporation pursuant to section 1297(c)) that would otherwise be passive income under the general rule is not passive income for purposes of section 1297 if the item would be excluded from passive income, determined by taking into account the activities performed by the officers and employees of the Tested Foreign Corporation as well as activities performed by the officers and employees of certain Look-Through Subsidiaries and certain partnerships in which the Tested Foreign Corporation or one of the Look-Through Subsidiaries is a partner. *See* proposed §1.1297-2(e)(1). In some cases, a Look-Through Subsidiary or Look-Through Partnership may have more than one unrelated owner owning at least 25 percent of the entity's value. Activities, unlike income or expense, are qualitative in nature and cannot be easily allocated between owners based on their percentage ownership. If activities are attributed to any owner of 25 percent or more of the Look-Through Subsidiary or partnership, then up to four owners could potentially be able to take into account the same activities. Because it may be difficult to allocate activities among multiple entities but inappropriate to allow double-counting of the activities by attributing the activities of a Look-Through Subsidiary or a partnership to multiple unrelated entities, the proposed regulations provide that a Tested Foreign Corporation may take into account the activities performed only by those Look-Through Subsidiaries or partnerships with respect to which the Tested Foreign Corporation owns (directly or indirectly) more than 50 percent of the value, because at this level of ownership the activities of the Look-Through Subsidiary or Look-Through Partnership could be attributed to only another foreign corporation within the same chain of ownership as the Tested Foreign Corporation and not an unrelated entity.

The Treasury Department and the IRS request comments on the application of the activity attribution rules to Look-Through Subsidiaries that are not wholly owned by a Tested Foreign Corporation, including whether it is appropriate for a Tested Foreign Corporation to take into account all activities of a Look-Through Subsidiary in which the Tested Foreign Corporation owns more than 50 percent of the value of the stock, and whether a different ownership threshold for attribution of activities would be appropriate.

The Treasury Department and the IRS also request comments on whether the ability to apply an exception to passive income at the Tested Foreign Corporation level taking into account the activities of certain subsidiaries should apply for purposes of other exceptions, such as for purposes of the exception in section 1297(b)(2)(A). Comments should consider the interaction of the rules for elimination of intercompany assets and income described in Part I.F.3 of this Explanation of Provisions with the rules for taking into account the activities of certain Look-Through Subsidiaries and Look-Through Partnerships.

6. Gain on the Disposition of Stock of a Look-Through Subsidiary

Section 1297(c) does not address the treatment of a Tested Foreign Corporation's gain from the disposition of stock of a Look-Through Subsidiary for purposes of the Income Test. Questions have been raised as to whether such a disposition should be treated as a disposition of stock or a deemed disposition of the assets of the Look-Through Subsidiary, and how gain on the disposition should be characterized for purposes of the Income Test.

The proposed regulations provide that, for purposes of the Income Test, the disposition of a Look-Through Subsidiary is treated as the disposition of stock, and gain is computed accordingly. However, the proposed regulations limit the amount of the gain taken into account for purposes of the Income Test in order to avoid double-counting any income that the Tested Foreign Corporation takes into account under section 1297(c) in determining the PFIC status of the Tested Foreign Corporation during the year of the disposition or took into account for such purpose in a prior year that has not been distributed as a dividend to the Tested Foreign Corporation. Thus, the amount of gain taken into account for purposes of the Income Test ("Residual Gain") is equal to the total gain recognized by the Tested Foreign Corporation on the disposition, reduced (but not below zero) by the amount (if any) by which (A) the aggregate income (if any) of the Look-Through Subsidiary (and any other Look-Through Subsidiary, to the extent stock in such other Look-Through Subsidiary is owned indirectly through the Look-Through Subsidiary) taken into account by the Tested Foreign Corporation under section 1297(c)(2) with respect to the disposed Look-Through Subsidiary stock exceeds (B) the aggregate dividends (if any) received by the Tested Foreign Corporation from the Look-Through Subsidiary with respect to the disposed stock (including dividends attributable to stock of any other Look-Through Subsidiary owned indirectly through the Look-Through Subsidiary). The Residual Gain is computed on a share-by-share basis with respect to income of a Look-Through Subsidiary that was taken into account by the Tested Foreign Corporation and dividends received from a Look-Through Subsidiary. *See* proposed §1.1297-2(f)(1). Comments are requested on the calculation of Residual Gain for purposes of section 1297(a).

Gain from the disposition of stock generally is treated as FPHCI under section 954(c)(1)(B)(i). However, section 954(c) does not contain a look-through rule comparable to section 1297(c). In order to comport with the policy underlying section 1297(c), the Treasury Department and the IRS have determined that the character of the gain from the disposition of a Look-Through Subsidiary should correspond to the character of the underlying assets of the Look-Through Subsidiary. Accordingly, proposed §1.1297-2(f)(2) provides that the Residual Gain taken into account by the Tested Foreign Corporation will be characterized as passive income or non-passive income in proportion to the passive assets and non-passive assets of the disposed-of Look-Through Subsidiary (and any other Look-Through Subsidiary, to the extent owned indirectly through the Look-Through Subsidiary) treated as held by the Tested Foreign Corporation pursuant to section 1297(c) on the date of the disposition, measured using the method (value or adjusted bases) that is used to measure the assets of the Tested Foreign Corporation for purposes of the Asset Test.

Pursuant to proposed §1.1297-1(c)(1)(i)(C), section 954(c)(4) applies with respect to the disposition of interests in a Look-Through Partnership. Comments are requested concerning whether any additional guidance is needed concerning the disposition of interests in a Look-Through Partnership.

G. *Change-of-business exception (including dispositions of stock of a Look-Through Subsidiary)*

Section 1298(b)(3) provides an exception from PFIC status (the "Change-of-Business Exception") for a Tested Foreign Corporation that is "in transition from one active business to another active business." H.R. Rep. No. 99-841, at II-644 (1986) (Conf. Rep.). Under section 1298(b)(3), the Change-of-Business Exception applies for a taxable year of the Tested Foreign Corporation if (i) neither the Tested Foreign Corporation nor a predecessor of the Tested Foreign Corporation was a PFIC in a prior taxable year; (ii) it is established to the satisfaction of the Secretary that (A) substantially all of the passive income of the Tested Foreign Corporation for the taxable year is attributable to proceeds from the disposition of one or more active trades or businesses, and (B) the Tested Foreign Corporation will not be a PFIC for either of the two taxable years following such taxable year; and (iii) the Tested Foreign Corporation is not, in fact, a PFIC for either of such two taxable years. Thus, notwithstanding the legislative history and the title of section 1298(b)(3), a Tested Foreign Corporation may qualify for the Change-of-Business Exception even if it does not engage in an active business after a disposition.

The proposed regulations provide general guidance with respect to the Change-of-Business Exception. First, the proposed regulations provide that for purposes of section 1298(b)(3)(B), the existence of an active trade or business and the determination of whether assets are used in an active trade or business is determined by reference to Treas. Reg. §1.367(a)-2(d)(2), (3), and (5), except that officers and employees do not include the officers and employees of related entities as provided in §1.367(a)-2(d)(3). *See* proposed §1.1298-2(c)(3). If, however, the activity attribution rules described in Part I.F.5 of this Explanation of Provisions or section 954(h)(3)(E) would apply to cause the activities of another entity to be taken into account, they are taken into account for purposes of determining the applicability of the Change-of-Business Exception. *Id.* In addition, the proposed regulations provide that income attributable to proceeds from the disposition of an active trade or business means income earned on investment of such proceeds but does not include the proceeds themselves. *See* proposed §1.1298-2(c)(1). The regulations also provide that section 1298(b)(3) may apply to either a taxable year of the disposition of the active trade or business or the immediately succeeding taxable year, but in any event may apply to only one year with respect to a disposition. *See* proposed §1.1298-2(e). Thus, a Tested Foreign Corporation that receives proceeds from a disposition in more than one taxable year may apply the Change-of-Business Exception to only one year. A Tested Foreign Corporation can choose which year it applies the Change-of-Business Exception if the exception can apply in more than one year.

Several comments have inquired regarding the application of the Change-of-Business Exception to the sale or exchange of stock of a Look-Through Subsidiary that conducts an active trade or business. Specifically, these comments have questioned whether, by reason of section 1297(c), the Tested Foreign Corporation should be treated as disposing of an active trade or business conducted by a Look-Through Subsidiary for purposes of the Change-of-Business Exception. The Treasury Department and the IRS have determined that, given that section 1297(c) applies "for purposes of determining whether [a] foreign corporation is a [PFIC]," the Change-of-Business Exception should, in appropriate circumstances, apply to a Tested Foreign Corporation's disposition of its interest in a Look-Through Subsidiary that is engaged in an active trade or business. Thus, the proposed regulations provide that, for purposes of the Change-of-Business Exception, a disposition of stock of a Look-Through Subsidiary is treated as a disposition of a proportionate share of the assets held by the Look-Through Subsidiary on the date of the disposition. *See* proposed §1.1298-2(d). Therefore, the portion of the proceeds attributable to assets used by a Look-Through Subsidiary in an active trade or business is considered for purposes of the Change-of-Business Exception to be proceeds from the disposition of an active trade or business.

The Treasury Department and the IRS also understand that Tested Foreign Corporations may not be able to satisfy the requirements of the Change-of-Business Exception provided in section 1298(b)(3) in certain situations in which proceeds from the disposition of an active trade or business cause the Tested Foreign Corporation to qualify as a PFIC pursuant to the Asset Test. The Treasury Department and the IRS have determined that if a Tested Foreign Corporation has historically engaged in an active trade or business and proceeds from the disposition of such business cause it to qualify as a PFIC, it may be appropriate in certain circumstances to which section 1298(b)(3) does not apply to treat the Tested Foreign Corporation as not a PFIC. Accordingly, the proposed regulations expand the Change-of-Business Exception in section 1298(b)(3) to apply if, on the measuring dates that occur during the taxable year to which the Change-of-Business Exception is proposed to apply and after the disposition, on average, substantially all of the passive assets of a corporation are attributable to proceeds from the disposition of one or more active trades or businesses. *See* proposed §1.1298-2(b)(2)(ii).

Furthermore, the Treasury Department and the IRS understand that in certain circumstances, the Change-of-Business Exception could apply to the liquidation of a Tested Foreign Corporation if it were not for the fact that foreign law restrictions make it difficult to complete the liquidation within the year for which the exception applies. The Treasury Department and the IRS have determined that it is appropriate to allow the Change-of-Business Exception to be relied upon when such a liquidation is completed within a reasonable period of time after the disposition. Accordingly, in the case of a corporation, substantially all of the passive assets of which are attributable to proceeds from the disposition of one or more active trades or businesses, proposed §1.1298-2(c)(4) provides that a Tested Foreign Corporation will be deemed to satisfy the requirement that the Tested Foreign Corporation not be a PFIC for the two years following the year for which it relies on the Change-of-Business Exception if it completely liquidates by the end of the year following the year for which it relies on the Change-of-Business Exception. U.S. Federal income tax principles apply to determine whether a Tested Foreign Corporation has completely liquidated. *See* Rev. Rul. 54-518, 1954-2 C.B. 142 (concluding that if a corporation ceases business operations, has retained no assets, and has no income, the mere retention of a charter does not prevent it from being treated as completely liquidated).

The Treasury Department and the IRS request comments concerning whether any other guidance is necessary concerning the application of section 1298(b)(3), including concerning the conditions under which the requirements of section 1298(b)(3)(C) will be considered satisfied.

H. *Domestic subsidiary stock rule*

As discussed in Part I.F.2 of this Explanation of Provisions, section 1298(b)(7) provides a special characterization rule that applies if a Tested Foreign Corporation owns at least 25 percent of the value of the stock of a domestic corporation and is subject to the accumulated earnings tax under section 531 (or waives any benefit under a treaty that would otherwise prevent imposition of such tax). The proposed regulations clarify that stock of the 25-percent-owned domestic corporation and the qualified stock generally must be owned by the Tested Foreign Corporation and the 25-percent-owned domestic corporation, respectively, either directly or indirectly through one or more partnerships. *See* proposed §1.1298-4(b)(1) and (c).

The Treasury Department and the IRS have determined that the accumulated earnings tax need not actually be imposed on a foreign corporation in a taxable year in order for it to qualify for section 1298(b)(7). Furthermore, a Tested Foreign Corporation's ability to rely on section 1298(b)(7) in a given year should not depend on whether it has U.S. source income in that year, as it would if §1.532-1(c) applied to determine whether the Tested Foreign Corporation was subject to tax under section 531. Accordingly, the regulations provide that a Tested Foreign Corporation is considered subject to the tax imposed by section 531 for purposes of section 1298(b)(7) regardless of whether the tax actually is imposed on the corporation and regardless of whether the requirements of §1.532-1(c) are met. *See* proposed §1.1298-4(d)(1). Additionally, comments have raised questions concerning the waiver of treaty benefits that would prevent imposition of the accumulated earnings tax. The proposed regulations provide that a Tested Foreign Corporation must waive any benefit under a treaty by attaching to its U.S. Federal income tax return for the taxable year for which it applies section 1298(b)(7) a statement that it irrevocably waives treaty protection against the imposition of the accumulated earnings tax, effective for all prior, current, and future taxable years. *See* proposed §1.1298-4(d)(2)(i). If a Tested Foreign Corporation is not otherwise required to file a U.S. Federal income tax return, the waiver can be made in a resolution (or other governance document) to be kept in the entity's records or, in the case of a publicly traded corporation, in a statement in the corporation's public filings. *See* proposed §1.1298-4(d)(2)(ii).

The Treasury Department and the IRS understand that foreign corporations may be relying on section 1298(b)(7) to avoid being treated as PFICs notwithstanding their direct and indirect ownership of predominantly passive assets by ensuring that a sufficient amount of such assets are held indirectly through two tiers of domestic subsidiaries. For example, a Tested Foreign Corporation might hold stock of another foreign corporation that is PFIC, but rely on a two-tiered domestic chain holding passive assets to avoid being treated as a PFIC; as a result, a United States person holding stock of the Tested Foreign Corporation would generally not be treated as a shareholder of the PFIC stock owned by the Tested Foreign Corporation. Accordingly, the proposed regulations provide that, notwithstanding the general coordination rule between section 1297(c) and section 1298(b)(7) in proposed §1.1297-2(b)(2)(iii), section 1298(b)(7) does not apply for purposes of determining if a foreign corporation is a PFIC for purposes of the ownership attribution rules in section 1298(a)(2) and Treas. Reg. §1.1291-1(b)(8)(ii). *See* proposed §1.1298-4(e). Thus, if a Tested Foreign Corporation would qualify as a PFIC if section 1298(b)(7) did not apply, either because section 1297(c) applied to treat the Tested Foreign Corporation as owning directly the assets of a domestic corporation in which it indirectly held qualified stock, or because the qualified stock was treated as a passive asset, then persons that held stock of a PFIC through the Tested Foreign Corporation would be considered under section 1298(a)(2)(B) and Treas. Reg. §1.1291-1(b)(8)(ii)(B) to own a proportionate amount (by value) of the stock of the PFIC regardless of the level of their ownership interest in the Tested Foreign Corporation.

To address the possibility of passive assets – particularly non-stock assets that could not themselves be eligible for the special treatment of section 1298(b)(7) – being held through a two-tiered chain of domestic subsidiaries in order to avoid the PFIC rules, the proposed regulations further provide anti-abuse rules under the authority of section 1298(g), one of which provides that section 1298(b)(7) will not apply if the Tested Foreign Corporation would be a PFIC if the qualified stock or any income received or accrued with respect thereto were disregarded. *See* proposed §1.1298-4(f)(1). Furthermore, under a second anti-abuse rule, section 1298(b)(7) will not apply if a principal purpose for the Tested Foreign Corporation's formation or acquisition of the 25-percent-owned domestic corporation is to avoid classification of the Tested Foreign Corporation as a PFIC. A principal purpose will be deemed to exist if the 25-percent-owned domestic corporation is not engaged in an active trade or business in the United States. *See* proposed §1.1298-4(f)(2). No inference is intended as to the application of section 1298(b)(7) under prior law. The IRS may, where appropriate, challenge transactions under the Code, regulatory provisions under prior law, or judicial doctrines. The Treasury Department and the IRS welcome comments on these rules.

II. *PFIC Insurance Exception Rules*

The proposed regulations provide guidance regarding whether the income of a foreign corporation is excluded from passive income pursuant to section 1297(b)(2)(B) because the income is derived in the active conduct of an insurance business by a QIC. Part II.A of this Explanation of Provisions describes the rules in proposed §1.1297-4 for determining whether a foreign corporation is a QIC. Part II.B of this Explanation of Provisions describes the rules in proposed §1.1297-5(c)(2) defining the term insurance business. Part II.C of this Explanation of Provisions describes the rules in proposed §1.1297-5(c) regarding the active conduct of an insurance business. Part II.D of this Explanation of Provisions describes the rules in proposed §1.1297-5(f) regarding the application of the section 1297(b)(2)(B) exception to items of income treated as received or accrued or assets treated as held by a QIC pursuant to section 1297(c). Part II.E of this Explanation of Provisions describes the rules in proposed §1.1297-5(d) regarding the treatment of income and assets of certain domestic insurance corporations owned by a QIC as active for purposes of 1297(a). Part II.F of this Explanation of Provisions describes the rule in proposed §1.1297-5(g) prohibiting the double counting of any item for purposes of proposed §§1.1297-4 and 1.1297-5.

A. *QIC status requirement*

Generally, section 1297(f) provides that a QIC is a foreign corporation that (1) would be subject to tax under subchapter L if it were a domestic corporation and (2) has applicable insurance liabilities that constitute more than 25 percent of its total assets. Proposed §1.1297-4 provides guidance regarding the requirements under section 1297(f)(1) that a foreign corporation must satisfy to qualify as a QIC.

1. Insurance Company Requirement

Proposed §1.1297-4(b)(1) provides guidance regarding when a foreign corporation would be the type of corporation that would be taxable under subchapter L (that is, an insurance company) if the corporation were a domestic corporation. *See* section 1297(f)(1)(A). It provides that a foreign corporation would be subject to tax under subchapter L if it were a domestic corporation if it is an insurance company as defined in section 816(a) (generally requiring more than half of the corporation's business during the taxable year to be the issuing of insurance or annuity contracts, or the reinsuring of risks underwritten by insurance companies).

2. 25 Percent Test

In addition to the insurance company requirement, generally a foreign corporation's "applicable insurance liabilities" (defined in section 1297(f)(3)(A) and proposed §1.1297-4(f)(2)) must exceed 25 percent of its "total assets" (defined in proposed §1.1297-4(f)(7) to be a QIC. Section 1297(f)(1)(B); *see also* proposed §1.1297-4(c). This determination is made on the basis of the foreign corporation's liabilities and assets as reported on the corporation's applicable financial statement for the last year ending with or within the taxable year. This test hereinafter is referred to as the "25 percent test." Proposed §1.1297-4(c) provides guidance regarding the application of the 25 percent test.

3. Alternative Facts and Circumstance Test

If a foreign corporation fails the 25 percent test, section 1297(f)(2) permits a United States person to elect to treat stock in the corporation as stock of a QIC under certain circumstances. Specifically, to make the election, the foreign corporation must be predominantly engaged in an insurance business, and its applicable insurance liabilities must constitute 10 percent or more of its total assets, hereinafter the "10 percent test." A United States person may only make this election if the foreign corporation fails the 25 percent test solely due to runoff-related or rating-related circumstances involving its insurance business, as further described in Part II.A.3.b of this Explanation of Provisions.

a. Predominantly engaged in an insurance business

Proposed §1.1297-4(d)(2) provides guidance regarding the circumstances under which a foreign corporation is predominantly engaged in an insurance business. In the case of a foreign corporation that fails the 25-percent test, Congress included the predominantly engaged requirement as part of the alternative facts and circumstances test to ascertain whether a foreign corporation is truly engaged in an insurance business despite the low ratio of applicable insurance liabilities to assets. *See* H.R. Rep. No. 115-466, at 671 (2017) (Conf. Rep.) ("Facts and circumstances that tend to show the firm may not be predominantly engaged in an insurance business include a small number of insured risks with low likelihood but large potential costs; workers focused to a greater degree on investment activities than underwriting activities ; and low loss exposure. Additional relevant facts for determining whether the foreign corporation is predominantly engaged in an insurance business include: claims payment patterns for the current year and prior years; the foreign corporation's loss exposure as calculated for a regulator or for a rating agency, or if those are not calculated, for internal pricing purposes; the percentage of gross receipts constituting premiums for the current and prior years; and the number and size of insurance contracts issued or taken on through reinsurance by the foreign corporation. The fact that a foreign corporation has been holding itself out as an insurer for a long period is not determinative either way."). The proposed regulations clarify that each of these factors is intended to be tested based on whether the particular facts and circumstances of the foreign corporation are comparable to commercial insurance arrangements providing similar lines of coverage to unrelated parties in arm's length transactions.

As noted in Part II.A.1 of this Explanation of Provisions, to qualify as an insurance company, more than one half of a corporation's business must be the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies. *See* sections 816(a) and 831(c). Although such a corporation might otherwise be considered to be "predominantly engaged" in an insurance business (where predominantly means "for the most part"), the predominantly engaged requirement of the alternative facts and circumstances test in section

1297(f) is separate from, and in addition to, the requirement that a corporation would be subject to tax under subchapter L if the foreign corporation were a domestic corporation. Therefore, in order to give effect to this predominantly engaged requirement, proposed §1.1297-4(d)(2) incorporates the specific factors enumerated in the legislative history as a part of a foreign corporation's analysis of whether it is predominantly engaged in an insurance business under the alternative facts and circumstances test, while retaining the requirement that "more than half" of the business be of a certain type, because the foreign corporation must separately satisfy that threshold with respect to the character of its insurance business under section 1297(f)(1)(A).

The Treasury Department and the IRS request comments regarding whether this proposed test appropriately determines whether a foreign corporation is predominantly engaged in an insurance business and invite comments on whether the proposed test would have material effects upon the way in which entities engaged in the provision of insurance are structured.

b. Runoff-related or rating-related circumstances

To qualify for the alternative facts and circumstances test, proposed §1.1297-4(d)(3) and (4) clarify the circumstances under which a foreign corporation fails to satisfy the 25 percent test solely due to runoff-related or rating-related circumstances involving its insurance business.

Proposed §1.1297-4(d)(3) provides that runoff-related circumstances occur when a corporation has adopted a plan of liquidation or termination of operations under the supervision of its applicable insurance regulatory body. Additionally, the corporation may not issue or enter into any new insurance, annuity, or reinsurance contracts during the taxable year (other than contractually obligated renewals of existing insurance contracts or reinsurance contracts pursuant to and consistent with the corporation's plan of liquidation or termination of operations) and must make payments during the annual reporting period covered by the applicable financial statement to satisfy the claims under insurance, annuity, or reinsurance contracts issued or entered into before the corporation ceased entering into new business.

Proposed §1.1297-4(d)(4) provides that rating-related circumstances occur when a generally recognized credit rating agency requires a foreign corporation to maintain a surplus of capital to receive or maintain a minimum credit rating for the foreign corporation to be classified as secure to write new insurance business for the current year. The Treasury Department and the IRS understand that it is possible that the minimum credit rating required to be classified as secure to write new insurance business may be higher for some lines of insurance business than for other lines of insurance business. For this purpose, the proposed rule is intended to apply to the highest minimum credit rating required to be classified as secure to write new insurance business for any line of insurance business.

The Treasury Department and the IRS understand that there may be certain lines of insurance business, such as financial guaranty insurance, where market realities require a credit rating in excess of the minimum credit rating for a foreign corporation to be classified as secure to write new insurance business in the relevant business line for the current year. The Treasury Department and the IRS request comments regarding this fact pattern and how best to address these lines of business in the context of the rating-related circumstances test.

c. Election to apply the alternative facts and circumstances test

Proposed §1.1297-4(d)(5)(i) generally requires that the foreign corporation with respect to which the election is made directly provide the United States person a statement or make a publicly available statement (such as in a public filing, disclosure statement, or other notice provided to United States persons that are shareholders of the foreign corporation) that it satisfied the requirements of section 1297(f)(2) and §1.1297-4(d)(1) during the foreign corporation's taxable year and certain information relevant to that statement. A United States person, however, may not rely upon any statement by the foreign corporation to make the election under section 1297(f)(2) if the shareholder knows or has reason to know that the statement made by the foreign corporation was incorrect. Because the foreign corporation possesses the information necessary to make an election under the alternative facts and circumstances test, the Treasury Department and the IRS have determined that it is appropriate to require a United States person to obtain that information from the foreign corporation in order to make the election. Comments are requested regarding the form and content of the statement provided by the foreign corporation to United States persons as set forth in proposed §1.1297-4(d)(5)(i)-(ii), and whether there are alternative ways of satisfying the requirements of 1297(f)(2).

Proposed §1.1297-4(d)(5)(iii) describes the time and manner for making the election. To make the election before final regulations are published, a United States person that owns stock of a foreign corporation electing to treat that stock as stock of a QIC under the alternative facts and circumstances test must file a limited-information Form 8621 (or successor form). For this purpose, a United States person must file a Form 8621 with the box checked regarding the QIC election and must provide the identifying information of the shareholder and the foreign corporation. The United States person is not required to complete any other part of Form 8621 if that person is only filing the Form 8621 to make the QIC election under the alternative facts and circumstances test.

The Treasury Department and the IRS request comments on ways to reduce burden on small shareholders with respect to the alternative facts and circumstances test.

4. Limitations on the amount of applicable insurance liabilities

When applying the 25 percent test to a foreign corporation, section 1297(f)(3)(B) provides that the amount of the foreign corporation's applicable insurance liabilities cannot exceed the lesser of (i) the amount that the foreign corporation reported to its "applicable insurance regulatory body" (defined in section 1297(f)(4)(B) and proposed §1.1297-4(f)(3)), (ii) the amount required by applicable law or regulation, or (iii) the amount determined under regulations prescribed by the Treasury Department and the IRS.

Proposed §1.1297-4(e) provides additional guidance regarding the limitation on the amount of applicable insurance liabilities for purposes of the 25 percent test and the 10 percent test. Specifically, the proposed regulations provide that the amount of applicable insurance liabilities may not exceed the lesser of (1) the amount shown on the most recent applicable financial statement; (2) the minimum amount required by applicable law or regulation of the jurisdiction of the applicable insurance regulatory body; and (3) the amount shown on the most recent financial statement made on the basis of U.S. generally accepted accounting principles ("US GAAP") or international financial reporting standards ("IFRS") if such financial statement was not prepared for financial reporting purposes. The Treasury Department and the IRS have determined that the additional limitations are necessary to clarify which financial statements are used to apply the 25 percent test and the 10 percent test, and that it is appropriate to limit the amount of applicable insurance liabilities to the minimum amount of liabilities required to be reported by an insurance regulator, even if the foreign corporation's regulator would accept a higher liability amount for regulatory purposes. In addition, under section 1297(f)(4), an applicable financial statement only includes financial statements made on the basis of US GAAP or IFRS if such a statement has been prepared for financial reporting purposes. If a foreign corporation prepares a financial statement on the basis of US GAAP or IFRS for a purpose other than financial reporting, the Treasury Department and the IRS have determined that the amount of applicable insurance liabilities under this financial statement, if lower than the amount on the applicable financial statement, is an appropriate limit on the amount of applicable insurance liabilities. This limitation is appropriate because Congress has expressed a preference for widely used standards of financial accounting through its references to such standards in section 1297(f)(4)(A).

Under the proposed regulations, a special rule applies with respect to applicable financial statements that are neither prepared under US GAAP nor IFRS. To the extent that such an applicable financial statement does not discount losses on an economically reasonable basis, the foreign corporation must reduce its applicable insurance liabilities to reflect discounting that would apply under either US GAAP or IFRS. The Treasury Department and the IRS have determined that a method of determining insurance liabilities that fails to provide for a reasonable discounting rate does not take into account a factor that is necessary to appropriately and accurately report the amount of applicable insurance liabilities. For this purpose, the question of whether losses are discounted on an economically reasonable basis is determined under the relevant facts and circumstances. However, in order for losses to be discounted on an economically reasonable basis, discounting must be based on loss and claim payment patterns for either the foreign corporation or insurance companies in similar lines of insurance business. In addition, a discount rate based on these loss and claim payment patterns of at least the risk free rate in U.S. dollars or in a foreign currency in which the foreign corporation conducts some or all of its insurance business must be used. A loss discounting methodology consistent with that used for US GAAP or IFRS purposes is considered reasonable for this purpose.

Finally, a special rule applies for certain foreign corporations that change their method of preparing their applicable financial statement by ceasing to prepare this statement under either US GAAP or IFRS and have no non-Federal tax business purpose for preparing a statement that is not consistent with US GAAP or IFRS. Under the proposed regulations, absent a non-Federal Tax business purpose, a foreign corporation must continue to prepare its applicable financial statement under either US GAAP or IFRS. If the foreign corporation fails to do so, the foreign corporation will be treated as having no applicable insurance liabilities for purposes of the QIC test. Absent this proposed rule, the Treasury Department and the IRS are concerned that a foreign corporation may change its method for preparing its financial statement to benefit from certain elements of a local regulatory accounting regime, such as a more expansive definition of insurance liability or a method of calculating a larger amount of insurance liabilities, solely for purposes of qualifying as a QIC. Comments are requested on this proposed rule.

B. *Insurance business*

For purposes of the PFIC insurance exception, proposed §1.1297-5(c)(2) defines an insurance business as the business of issuing insurance and annuity contracts or reinsuring risks underwritten by other insurance companies (or both). Under the proposed regulations, an insurance business also includes the investment activities and administrative services required to support (or that are substantially related to) those insurance, annuity, or reinsurance contracts issued or entered into by the QIC. Proposed §1.1297-5(h)(2) provides that investment activities are any activities that generate income from assets that a QIC holds to meet its obligations under insurance and annuity contracts issued or reinsured by the QIC.

C. *Active conduct*

To give effect to the active conduct requirement, the 2015 proposed regulations differentiated between activities performed by a corporation through its officers and employees and activities performed by other persons (for example, employees of other entities or independent contractors) for the corporation. The 2015 proposed regulations accomplished this separation by defining the term "active conduct" in section 1297(b)(2)(B) to have the same meaning as in §1.367(a)-2T(b)(3) (now §1.367(a)-2(d)(3)), except that officers and employees would not have included the officers and employees of related entities. Hence, under the 2015 proposed regulations, only insurance investment business activities performed by a corporation's officers and employees would be included in the corporation's active conduct of its insurance business. Accordingly, under the 2015 proposed regulations, investment income would have qualified for the PFIC insurance exception only if the corporation's own officers and employees performed the insurance business activities that produce the income.

Proposed §1.1297-5(c)(3)(i) provides that the term active conduct is based on all of the facts and circumstances and that, in general, a QIC actively conducts an insurance business only if the officers and employees of the QIC carry out substantial managerial and operational activities. For this purpose, active conduct is intended to be interpreted consistently with the active conduct standard in §1.367(a)-2(d)(5). The proposed regulation further provides that a QIC's officers and employees are considered to include the officers and employees of another corporation if the QIC satisfies the control test set forth in proposed §1.1297-5(c)(3)(ii). Generally, to satisfy the control test, (i) the QIC must either own, directly or indirectly more than 50 percent of the vote and value (for a corporation) or capital and profits interest (for a partnership) of the entity whose officers or employees are performing services for the QIC or (ii) a common parent must own, directly or indirectly, more than 80 percent of the vote and value or capital and profits interest of both the QIC and the entity performing services for the QIC. In addition, the QIC must exercise regular oversight and supervision over the services performed by the other entity's officers and employees for the QIC. The QIC must also either (i) pay directly all the compensation of the other entity's officers and employees attributable to services performed for the QIC for the production or acquisition of premiums and investment income on assets held to meet obligations under insurance, annuity, or reinsurance contracts issued or entered into by the QIC; (ii) reimburse the other entity for the portion of its expenses, including compensation and related expenses (determined in accordance with section 482, taking into account all expenses that would be included in the total services costs under §1.482-9(j) and §1.482-9(k)(2)) and add a profit markup, as appropriate, for these services performed for the QIC by the other entity's officers and employees; or (iii) otherwise pay arm's length compensation in accordance with section 482 on a fee-related basis to the other entity for the services provided to the QIC. For example, it is common to charge for investment advisory or management services via a fee calculated as a percentage of the underlying assets under management (AUM), and a fee calculated on this basis may be arm's length under section 482 principles.

Under proposed §1.1297-5(c)(4), a QIC determines the annual amount of its income that is derived in the active conduct of an insurance business (the active conduct test) and excluded from passive income under section 1297(b)(2)(B) for purposes of section 1297(a). To make this determination, the QIC must determine its active conduct percentage.

If the QIC's active conduct percentage is greater than or equal to 50 percent, then all of the QIC's passive income (as defined in §1.1297-1, taking into account the exceptions in section 1297(b)(2) other than section 1297(b)(2)(B) and §1.1297-5) is excluded from passive income pursuant to the exception in section 1297(b)(2)(B) for the active conduct of an insurance business. If the QIC's active conduct percentage is less than 50 percent, then none of its income is excluded from passive income pursuant to the exception in section 1297(b)(2)(B) for the active conduct of an insurance business. In response to comments made to the 2015 proposed regulations, the active conduct percentage is based on the QIC's expenses to provide a bright-line test for measuring the QIC's active conduct. The Treasury Department and the IRS determined that the amount of expenses for insurance activities performed by the QIC (or by a related party) as compared to the total expenses of the QIC indicates the extent to which the QIC conducts the business itself and therefore, actively engages in an insurance business.

The Treasury Department and the IRS request comments on the following topics:

1. Whether the relative amount of expenses for insurance activities performed by the QIC accurately assesses whether a QIC is engaged in the active conduct of an insurance business.
2. The contours of the control test, which allow for a QIC to benefit from a higher active conduct percentage based on activities (paid for by the QIC) of an entity in which a common parent, but not the QIC itself, owns more than 80 percent of the interests. The Treasury Department and IRS propose this standard based on an understanding of common ownership structures in the insurance industry, and note that the attribution of activities described in Part I.F.5 of this Explanation of Provisions (regarding the active rent or royalty exception) is more limited as it provides that a Tested Foreign Corporation may take into account the activities performed only by those Look-Through Subsidiaries or partnerships with respect to which the Tested Foreign Corporation owns (directly or indirectly) more than 50 percent of the value.
3. The active conduct percentage calculation in general, including whether this test should be the only test for determining whether income is derived in the active conduct of an insurance business or whether such a percentage would better serve as an objective safe harbor alongside a facts and circumstances test.

D. Treatment of income and assets of certain Look-Through Subsidiaries and Look-Through Partnerships held by a QIC

Proposed §1.1297-5(f) provides that certain items of income and assets that are passive in the hands of a look-through subsidiary or look-through partnership may be treated as active by a QIC. Under this provision, a Tested Foreign Corporation is treated as if it directly holds its proportionate share of the assets and as if it directly receives its proportionate share of the income of the Look-Through Subsidiary or Look-Through Partnership. Generally, if the income or assets are passive in the hands of the Look-Through Subsidiary or Look-Through Partnership, the income or assets are treated as passive income and passive assets of the Tested Foreign Corporation. However, if the Tested Foreign Corporation is a QIC, the income and assets are tested under section §1.1297-5(c) and (e) to determine if they qualify for the section 1297(b)(2)(B) insurance exception to passive income. However, for this rule to apply, the Look-Through Subsidiary or Look-Through Partnership, as the case may be, must have its assets and liabilities included in the applicable financial statement of the foreign corporation for purposes of the 25 percent test and the 10 percent test. This rule does not change the character of the items of income or assets as passive income or passive assets to the Look-Through Subsidiary or Look-Through Partnership.

E. *Qualifying domestic insurance corporations*

Proposed §1.1297-5(d) provides that income of a qualifying domestic insurance corporation is not treated as passive income. Similarly, proposed §1.1297-5(e)(2) provides that assets of a qualifying domestic insurance corporation are not treated as passive assets. A qualifying domestic insurance corporation is a domestic corporation that is subject to tax as an insurance company under subchapter L of chapter 1 of subtitle A of the Code and is subject to Federal income tax on its net income. This rule is intended to address situations where a Tested Foreign Corporation owns a domestic insurance corporation through a structure to which section 1298(b)(7) does not apply.

F. *No double counting rule*

Proposed §1.1297-5(g) provides that nothing in proposed §1.1297-4 or §1.1297-5 permits any item to be counted more than once (for example, for determining a reserve or an applicable insurance liability for purposes of the 25 percent test and the 10 percent test). Including this general principle is consistent with subchapter L provisions that do not allow double counting. For example, section 811(c)(2) provides that the same item may not be counted more than once for reserve purposes, section 811(c)(3) provides that no item may be deducted (either directly or as an increase in reserves) more than once, and section 832(d) prohibits the same item from being deducted more than once.

Applicability Dates

These regulations are proposed to apply to taxable years of United States persons that are shareholders in certain foreign corporations beginning on or after the date of publication of the Treasury decision adopting these rules as final regulations in the **Federal Register**. However, until these regulations are finalized, taxpayers may choose to apply these proposed regulations (other than the proposed regulations under §§1.1297-4 and 1.1297-5) in their entirety to all open tax years as if they were final regulations provided that taxpayers consistently apply the rules of these proposed regulations. Until finalization, United States persons that are shareholders in certain foreign corporations may apply the rules of §§1.1297-4 and 1.1297-5 for taxable years beginning after December 31, 2017, provided those United States persons consistently apply the rules of §§1.1297-4 and 1.1297-5 as if they were final regulations. In addition, taxpayers may continue to rely on Notice 88-22 until these regulations are finalized.

Special Analyses

I. *Regulatory Planning and Review – Economic Analysis*

Executive Orders 13771, 13563, and 12866 direct agencies to assess costs and benefits of available regulatory alternatives and, if regulation is necessary, to select regulatory approaches that maximize net benefits, including potential economic, environmental, public health and safety effects, distributive impacts, and equity. Executive Order 13563 emphasizes the importance of quantifying both costs and benefits, reducing costs, harmonizing rules, and promoting flexibility. The Executive Order 13771 designation for any final rule resulting from the proposed regulation will be informed by comments received. The preliminary Executive Order 13771 designation for this proposed rule is regulatory.

The proposed regulation has been designated by the Office of Information and Regulatory Affairs (OIRA) as significant under Executive Order 12866 pursuant to the Memorandum of Agreement (MOA, April 11, 2018) between the Treasury Department and the Office of Management and Budget regarding review of tax regulations.

A. *Background*

Various provisions of the tax code allow tax on certain sources of income to be deferred, which means that the income is not taxed when it is earned but at some later date, based on specific events or conditions. Tax deferral is advantageous to taxpayers because the taxpayer can in the meantime earn a return on the amount that would otherwise have been paid as tax. Prior to the Act, income earned abroad generally was not taxed until it was repatriated to the United States. After the Act, income earned abroad by a CFC is generally taxed immediately to the United States shareholders of the CFC, but income earned by foreign corporations that are not CFCs, particularly where the owners of the foreign corporations are individuals or other entities not eligible for the dividends received deduction under section 245A, may still be eligible for deferral. However, deferral is not available with respect to income of foreign corporations that earn primarily certain kinds of passive income, which in general includes dividends, interest, royalties, rents, and certain gains on the exchange of property, commodities, or foreign currency. Limiting deferral of foreign source income discourages U.S. taxpayers from holding mobile, passive investments, such as stock, in a foreign corporation in order to defer U.S. tax.

A particular set of rules limiting deferral applies to U.S. persons who own interests in passive foreign investment companies ("PFICs"). In general, a PFIC is a foreign corporation that, in a given year, has income that is 75 percent or more passive income or that owns, on average, assets that are 50 percent or more passive-income-producing. Taxpayers subject to another set of rules limiting deferral, the subpart F rules, are not subject to the PFIC rules.

Long-standing sections 1291 through 1298 provide rules regarding the tax treatment of income from PFICs. The PFIC itself is not subject to U.S. tax under the PFIC regime; rather, only the U.S. owner of the PFIC is required to determine whether he or she has invested in a PFIC, and if so, what tax is due as a result. The U.S. owner is responsible for getting the appropriate information from the foreign corporation to determine if the corporation is a PFIC.

Before its amendment by the Act, the PFIC provisions provided an exception from passive income for any income (including investment income) earned in the active conduct of an insurance business by a foreign corporation that (i) was predominantly engaged in an insurance business and (ii) would be taxed as an insurance company if it were a domestic corporation. Congress determined that this exception enabled U.S. owners of some foreign insurance companies to escape the PFIC regime. This exception, (the "PFIC insurance exception"), was established because insurance companies must hold significant amounts of investment assets (which generate income that would otherwise be classified as passive under the PFIC rules) in the normal course of business to fund obligations under the insurance contracts they issue. Staff, Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986, JCS-10-87, at 1025 (1987); IRS, Corporate Income Tax Returns Complete Report, 2013, Table 1).

The Act modified and narrowed the PFIC insurance exception by requiring that the excepted income be derived in the active conduct of an insurance business by a "qualifying insurance corporation" ("QIC"). To be a QIC, a foreign insurance corporation must be an entity that would be taxed as an insurance company if it were a domestic corporation (consistent with prior-law requirements) and, in addition, be able to show that its "applicable insurance liabilities" constitute more than 25 percent of its total assets. The Act specifically defines applicable insurance liabilities for this purpose as including a set of enumerated types of insurance-related loss and expense items. Failing this test, the Code provides that U.S. owners of the foreign corporation may elect to treat their stock in the corporation as stock of a QIC, provided the corporation can satisfy an "alternative facts and circumstances test." However, once a corporation has been identified as a QIC, only income that is derived in the active conduct of an insurance business qualifies as income eligible for the PFIC insurance exception.

Congress modified section 1297 under the Act out of concern that the active insurance company exception to the PFIC rules lacked clarity and precision. This lack of clarity with respect to how much insurance business the company must do to qualify under the exception raised concerns that certain companies with U.S. shareholders were structuring themselves to take advantage of the exception but conducting a token insurance business while focusing primarily on investment activities. Such strategies erode the U.S. tax base, and reflect inefficient investment incentives for U.S. taxpayers. As a result, the Act adopted a more formulaic rule that is easier to enforce and apply, while still allowing a facts and circumstances approach for showing insurance activity. *See* Senate Budget Explanation of the Bill (2017-11-20) at p. 397.

B. *Need for the proposed regulations*

The Treasury Department and the IRS view the Act modifications regarding PFIC determination as generally self-executing (although regulatory guidance is needed in order for U.S. owners to elect QIC status under the facts and circumstances test), which means that the statute is binding on taxpayers and the IRS without further regulatory action. The Treasury Department and the IRS recognize, however, that the statute provides interpretive latitude for taxpayers and the IRS that could, without further guidance, prompt inefficient investment patterns due to divergent interpretations. Consequently, many of the details behind the relevant terms and necessary calculations required for the determination of PFIC status would benefit from greater specificity. The proposed regulations provide details and specifics for the definitions and concepts described in sections 1291, 1297, and 1298 so that taxpayers can readily and accurately determine if their investment is in a PFIC, given the significant consequences of owning a PFIC, which may continue to be treated as such even after the foreign corporation ceases to satisfy the Income Test or Asset Test. *See* section 1298(b)(1). The regulations further resolve ambiguities in determining ownership of a PFIC and in the application of the Income Test and Asset Test under the statutory provisions that existed prior to the Act.

The Treasury Department and the IRS have also identified actions that foreign companies might take to qualify for QIC designation even though the nature of their active insurance business would not merit QIC designation under the intents and purposes of the statute. The proposed regulations are needed to avoid the inefficient economic decisions that would arise from those tax avoidance actions. For example, in the absence of the proposed regulations, taxpayers may be incentivized to adopt accounting methods that inappropriately inflate applicable insurance liabilities or exaggerate the degree to which income of a QIC is derived in the active conduct of an insurance business.

C. *Overview of the proposed regulations*

The proposed regulations can be divided into two parts. The rules described in Part I of the Explanation of Provisions section of this preamble provide general guidance regarding PFICs (the "General Rules"). *See* Part I.D.2 of this Special Analyses section. The rules described in Part II of the Explanation of Provisions section of this preamble relate specifically to the implementation of the PFIC insurance exception (the "PFIC Insurance Exception Rules"). *See* Part I.D.3 of this Special Analyses section. Among other things, the General Rules (1) describe and clarify how assets are measured for the asset test; and (2) clarify attribution rules for determining some forms of active income. The PFIC Insurance Exception Rules provide guidance regarding qualification for the PFIC insurance exception, define statutory terms relevant to QIC status, and provide instructions on electing QIC status under the alternative facts and circumstances test.

D. *Economic analysis*

1. Baseline

The Treasury Department and the IRS have assessed the benefits and costs of the proposed regulations relative to a no-action baseline reflecting anticipated Federal income tax-related behavior in the absence of these proposed regulations.

2. Summary of Economic Effects

The proposed regulations provide certainty and consistency in the application of sections 1291, 1297, and 1298 with respect to PFICs and QICs by providing definitions and clarifications regarding the statute's terms and rules. In the absence of such guidance, the chances that different U.S. owners (or potential owners) of foreign companies would interpret the statute differentially, either from each other or from the intents and purposes of the statute, would be exacerbated. This divergence in interpretation could cause U.S. investors to choose investment vehicles based on different interpretations of, for example, whether particular income would avoid qualifying as passive income and thus avoid the less favorable tax treatment applied by the PFIC regime. If economic investment is not guided by uniform incentives across otherwise similar investors and across otherwise similar investments, the resulting pattern of investment is generally inefficient, conditional on the Code's provisions governing passive income.[1] In the context of U.S. investment in foreign insurance corporations, the proposed regulations help to ensure that similar economic activities, representing similar passive and non-passive attributes, are taxed similarly. Thus, the Treasury Department and the IRS expect that the definitions and guidance provided in the proposed regulation will lead to an improved allocation of investment among taxpayers contingent on the overall Code.

The Treasury Department and the IRS have not quantified the expected economic benefits or the costs to the U.S. economy, or the scope of taxpayers benefitting from or burdened by the proposed regulations. The Treasury Department and the IRS request comment on these issues and particularly solicit comments that provide data, evidence, or models that would enhance the rigor by which the non-revenue economic effects might be determined and quantified for the final regulations.

The following sections describe the economic effects of specific major provisions of these proposed regulations relative to possible alternative provisions. The Treasury Department and IRS solicit comments on each of the items discussed subsequently and on any other provisions of the proposed regulations not discussed in this section. The Treasury Department and the IRS particularly solicit comments that provide data, other evidence, or models that could enhance the rigor of the process by which these or further provisions might be developed for the final regulations.

3. Economic Analysis of Specific Provisions of the General Rules

a. Averaging period for the Asset Test

A foreign corporation is considered a PFIC if it satisfies either of the following tests: (i) 75 percent or more of the corporation's gross income for a taxable year is passive ("Income Test"); or (ii) the average percentage of assets held by the corporation during the year producing passive income is at least 50 percent ("Asset Test"). If a foreign corporation is a PFIC, the U.S. owner of the PFIC is subject to tax under the PFIC regime. Regarding the Asset Test, section 1297(e) provides rules for how to determine the value of assets using either the fair market value or the adjusted basis, but does not indicate what period should be used to determine the "average percentage." Notice 88-22, which was issued following the enactment of the PFIC regime to provide guidance on a number of issues related to the Income and Asset Tests pending regulations, required taxpayers to determine value at the end of each quarter and average those numbers on an annual basis for the test. *See* Part I.D.1 of the Explanation of Provisions section of this preamble. Notice 88-22 announced the intention of the Treasury Department and IRS to issue regulations addressing this and other issues under the PFIC regime; however, no regulations addressing the Asset Test were issued until the proposed regulations.

To remedy this omission and specify the period over which the average percentage would be calculated, the Treasury Department and the IRS considered three alternatives: (i) semi-annual measurement, (ii) quarterly measurement, and (iii) daily measurement.[2] The Treasury Department and the IRS also considered, once a default measuring period was set, offering flexibility to shareholders to determine their own measurement period as long as the period was shorter than the default period. In each respective case, the Asset test would be based on the annual average of the semi-annual, quarterly, or daily asset values.

The first option, to require taxpayers to determine the average value of assets that produce passive income on a semi-annual basis, has lower costs than the other suggested approaches since calculations have to be done just twice a year and these costs (or cost-savings) are borne directly or indirectly by the owners of the corporation. The benefit of these lower costs to U.S. taxpayers must be balanced against the projected accuracy of semi-annual measurement. Because the period examined is long, semi-annual amounts are relatively easy for the corporation to manipulate so as to avoid having 50 percent or more passive-income producing assets as measured by value over the averaging period discussed here (the Asset Test) and therefore avoid PFIC treatment, even in cases where the company held significant amounts of passive-income-producing assets during the year.

The third option, to require taxpayers to average daily asset values for the asset test, provides a more exact measure of the assets of the company but the costs for the company to provide such information to their owners can be significant and some companies might choose not to provide such calculations to their small U.S. owners.[3] On the other hand, daily measurement would make it costly for the entity to avoid PFIC determination by "removing" assets generating passive income at measurement times.

The proposed regulations, consistent with the second option, require at least quarterly measurement and further allow taxpayers to elect to use a shorter period, such as monthly or daily measurement of asset values. Shorter period alternatives (relative to a semi-annual period) curtail the ability of foreign corporations to avoid PFIC designation through asset management strategies that would be tax-driven rather than market-driven. The Treasury Department and the IRS project that the increase in compliance costs of quarterly measurement over semi-annual measurement would be minor, because quarterly measurement aligns with general accounting practices, and because many taxpay-

[1] General economic principles do not clearly prescribe the efficient relative tax treatment of passive income versus non-passive income and therefore do not indicate whether a shift in investment from passive-income-producing activities to non-passive-income-producing activities is economically beneficial. This economic analysis draws conclusions about the efficient tax treatment of different investments by evaluating incentives in light of the intents and purposes of the underlying statutes.

[2] Other units could have been considered, such as months or weeks, but these three options span the reasonable possibilities.

[3] It would further generally be difficult for a U.S. owner to calculate, on his or her own, the value of PFIC assets on a daily basis, especially if the owner were a minority shareholder.

ers were likely already relying on the provision in Notice 88-22 that provided for quarterly measurement. The election to choose monthly or daily measurement allows U.S. persons who own interests in foreign corporations to use even more precise measurement of asset holdings if, based on business-specific accounting practices and the availability of that information to the U.S. person, the U.S. person deems that any higher compliance costs they might incur are warranted.

The Treasury Department and IRS solicit comments on this proposal, particularly comments that provide data, other evidence, or models that could enhance the rigor of the process by which the average percentage period might be developed for the final regulations.

b. Attribution of activities

For purposes of determining whether a corporation is a PFIC, section 1297(c) treats a foreign corporation (FC1) that owns 25 percent or more of another foreign corporation (FC2) as owning and earning the proportional amount of FC2's income and assets under the so called Look-Through Subsidiary rules.[4] However, the statute is silent on whether the activities of FC2 can be attributed to FC1 for purposes of determining whether the income of FC1 qualifies as being treated as non-passive income. Under current practice, some businesses structure their organization for legal or commercial reasons to have all employees for a business in one corporation, say FC2, while the rents and royalties are received by FC1. Without attribution of activities, FC1 could not qualify for an exception that treats these rents and royalties as active, as opposed to passive, income. This could result in FC1 being treated as a PFIC even though, on the whole, its income and economic activities were related to active business operations and not comparable to the passive income generating activities generally undertaken by PFICs.

To address the attribution of activities in foreign businesses in structures similar to those described, the Treasury Department and the IRS considered three alternatives: (1) do not allow any attribution of activities; (2) allow attribution of activities to multiple U.S. owners; or (3) allow attribution only if there is greater than a 50 percent ownership percentage; that is, if the foreign corporation owns more than 50 percent of the other foreign corporation.

Under the first alternative (no attribution), a foreign corporation that separated activities and income could satisfy the passive income exception only if it reorganized such that the entity being tested as a PFIC received both the active rents and royalties as well as had the employees that performed the related activities. This is potentially costly or even infeasible, depending on local requirements. The Treasury Department and the IRS determined that this alternative would potentially lead to costly reorganization, a cost that would either be passed on to U.S. investors or that, in the absence of such reorganization, would inhibit U.S. investment in a foreign corporation that was otherwise similar to corporations that were not PFICs. These are economically undesirable outcomes in light of the intents and purposes of the statute, relative to the proposed regulations.

Under the second alternative, activities could be attributed similarly to how the Look-Through Rule attributes income and assets. In general, because the Look-Through Rule requires ownership of only 25 percent of a foreign corporation in order to apply, the income and assets of a foreign corporation may be attributed to multiple owners. The statute specifies that this be done on a pro rata basis — for example, if a U.S. person owns 100 percent of foreign corporation (FC1) that owns 60 percent of FC2, 60 percent of the income and assets of FC2 could be attributed to FC1 for purposes of applying the Income and Asset tests, and 40 percent of the income and assets could be allocated to another shareholder of FC2. This alternative generates significant difficulties, however, in the context of attribution of activities. While income and assets can be allocated between owners based on percentage ownership, activities are not measured by a numerical amount and thus are not easily separated between two owners. Additionally, allowing multiple shareholders to use the activities of a single corporation to treat income as non-passive could result in double counting of activities (i.e., attributing the same activity to multiple parent companies). The Treasury Department and the IRS determined that potential double counting of activities could result in less tax revenue being raised than intended by Congress.

Under the third alternative, the activities of a foreign corporation could only be attributed to one shareholder. The proposed regulations adopt this third alternative, specifically by allowing attribution if there is an ownership percentage greater than 50 percent. Thus, where FC1 owns 60 percent of FC2 and another shareholder owns the remaining 40 percent, only FC1 could get credit for the activities of FC2 for purposes of applying the active rents and royalties test. No other shareholder of FC2 would qualify for attribution. The Treasury Department and the IRS project that this proposed regulation would allow entities to satisfy the passive income exception under conditions consistent with the intents and purposes of the statute without requiring potentially substantial reorganization costs.

The Treasury Department and the IRS solicit comments on this proposal and in particular solicit data, evidence, or models that could enhance the rigor of the process by which the ownership percentage might be developed for the final regulations.

c. Look-Through Partnerships

As discussed in Part I.D.3.b of this Special Analyses, for purposes of determining whether a corporation is a PFIC, section 1297(c) treats a foreign corporation (FC1) that owns 25 percent or more of another foreign corporation (FC2) as owning and earning the proportional amount of FC2's income and assets under the so called Look-Through Subsidiary rules. Absent this rule, any distributions from FC2 to FC1 would generally be treated as passive income to FC1 for purposes of the Income Test, and the stock of FC2 would general-

[4] For purposes of the rest of this discussion, FC1 can be considered the parent corporation with U.S. owners that is tested as to whether it is a PFIC or not. FC2 is a subsidiary of FC1.

ly be treated as a passive income-producing asset for purposes of the Asset Test. The statute does not provide any specific rule for the treatment of a partnership interest owned by a foreign corporation for purposes of determining whether the foreign corporation is a PFIC.

In order to provide guidance on the treatment of partnership interests owned by foreign corporations for purposes of the Income and Asset Tests, the Treasury Department and the IRS considered three principal alternative thresholds regarding when to treat the income and assets of a partnership as earned or held directly by the foreign corporation. These thresholds are: (1) apply no threshold; (2) apply a 10 percent threshold; or (3) apply the same 25 percent ownership threshold to partnership interests as is applied to interests in corporations.

Under the first alternative, a proportionate share (based on the foreign corporation's capital or profits interest in the partnership) of the income and assets of the partnership would be considered as earned or held directly by the foreign corporation for purposes of determining whether the foreign corporation is a PFIC, no matter how much of the partnership was owned by the foreign corporation. A similar rule to this applies for purposes of the subpart F regime, and thus there could be benefits in applying consistent rules across the two regimes. However, the purpose of the Income and Asset Tests is to determine whether the foreign corporation has a primarily active or passive business. An ownership interest of less than 10 percent is unlikely to give the foreign corporation significant control over the partnership activities such that it represents an active business interest. Additionally, providing a lower threshold for partnership interests, by contrast to the threshold applicable to corporate interests, creates incentives for foreign corporations to hold minority interests in partnerships rather than corporations, and in some cases, because of the U.S. entity classification rules, the classification of the entity as a partnership may be solely for U.S. tax purposes. This means that the same investment that Congress determined could only be active if it accounted for 25 percent of the value of the entity would now qualify as active even though the nature of the investment has not substantially changed. This latter case is economically undesirable since it can result in differential tax treatment of corporations and partnerships. Moreover, this outcome is less consistent with the intents and purposes of the statute, than the approach taken in the proposed regulations. Under the second alternative, a proportionate amount of the income and assets of the partnership would be considered as earned or held directly by the foreign corporation only if the foreign corporation owned 10 percent or more of the partnership. Existing rules under section 904, which relates to the foreign tax credit limitation, utilize a 10 percent threshold for purposes of determining whether to characterize income and assets of a partnership as passive category income and assets. There could be benefits in applying an existing threshold from the foreign tax credit regime to PFICs since taxpayers would be familiar with this regime. However, similar to the no threshold option, because section 1297(c)(2) requires a 25 percent ownership for corporations to apply for the Look-Through Subsidiary rules, this alternative would still lead to differing treatment of minority interests in subsidiary corporations as opposed to partnerships. Again, this could lead to similarly situated entities being treated differently and resultant economic distortions.

Under the third alternative, the same 25 percent ownership threshold is applied to partnership interests as is applied to interests in corporations. The Treasury Department and IRS project this will maintain parity between the treatment of minority interests in corporations and partnership interest for purposes of the Income and Asset test, and it gives effect to the 25 percent limitation in section 1297(c)(2). The Treasury Department and the IRS project that this proposed regulation would achieve consistent treatment across entity types as well as the appropriate treatment of minority interests in corporations and partnerships under conditions consistent with the intents and purposes of the statute.

The Treasury Department and the IRS solicit comments on this proposal and in particular solicit data, evidence, or models that could enhance the rigor of the process by which the treatment of partnership interests might be developed for the final regulations.

4. Economic Analysis of PFIC Insurance Exception Rules

Under the statute, the income of a qualifying insurance corporation (QIC) derived in the active conduct of its insurance business is not treated as passive income for purposes of deciding whether the corporation is a PFIC. The test for a QIC under section 1297(f) is based on the ratio of the foreign insurance company's "applicable insurance liabilities" to its total assets. The statute limits the applicable insurance liabilities to the smallest: of: (1) the insurance liabilities shown on the company's most recent applicable financial statement ("AFS"); (2) the amount of such liabilities required by applicable local law or regulation, and (3) as provided under Treasury regulations.

Under the statute, the AFS is the financial statement used by the foreign corporation for financial reporting purposes that is: (i) made on the basis of U.S. generally accepted accounting principles ("US GAAP"); (ii) made on the basis of international financial reporting standards ("IFRS"), if there is no statement that is made on the basis of US GAAP; or (iii) the annual financial statement required to be filed with the applicable insurance regulatory body ("local accounting"), if the company does not prepare a statement for financial reporting purposes based on US GAAP or IFRS. Thus, the statute has a preference for financial statements prepared on the basis of US GAAP or IFRS, which are rigorous and widely-respected accounting standards, but will permit a foreign corporation to use a local accounting AFS if it does not do financial reporting based on US GAAP or IFRS.

The statute creates an incentive for foreign insurance companies (FCos) to inflate applicable insurance liabilities in order to qualify as QICs and avoid PFIC status. This strategy (inflating applicable insurance liabilities to qualify as a QIC) could make the FCo more attractive to U.S. investors relative to investing in a domestic company or a company that is a PFIC, which could potentially lead to investment patterns that are inefficient. Although the statutory caps on applicable insurance liabilities provide a check on this behavior, FCos (and thus their U.S. owners) might look for options under their financial reporting rules to increase the amount of insurance liabilities reported on their AFS, or even shift to a different financial reporting standard with more favorable rules. The proposed regulations address this issue in a number of ways.

a. Change in accounting rules used for an AFS

The statute may, in some circumstances, introduce an incentive for an FCo to change its method of preparing its AFS to benefit from certain elements of a local accounting regime, such as a more expansive definition of insurance liability or a method of calculating a larger amount of insurance liabilities, solely for purposes of increasing its applicable insurance liabilities in order to qualify as a QIC. This strategy, by allowing a company to avoid being characterized as a PFIC and thus providing an incentive for U.S. investors to route their investment dollars through foreign corporations that otherwise would fail the QIC test, yields a potential tax advantage to U.S. investors relative to other investments they might make, an outcome that is economically inefficient in light of the intents and purposes of the statute.

To address this issue, the proposed regulations provide a special rule for FCos that change their method of preparing their AFS by ceasing to prepare this statement under either US GAAP or IFRS without a non-Federal tax business purpose for the change. Under the proposed regulations, an FCo must continue to prepare its AFS under either US GAAP or IFRS and if it fails to do so, it will be treated as having no applicable insurance liabilities for purposes of the QIC test.

The Treasury Department and the IRS considered as an alternative not providing regulations to address a change in the method of preparing an AFS. The Treasury Department and the IRS do not have readily available data to allow estimation of the tax advantage or volume of investment that might be drawn to such companies (and away from others) in the absence of regulations to address a change in the method of preparing an AFS. The Treasury Department and the IRS further have not estimated the benefit that arises from the improved integrity of the tax system under the proposed regulations relative to not providing regulations to govern changes in the FCo's AFS method. The Treasury Department and the IRS solicit comments on all aspects of these proposed regulations, including comments on (1) the determination of a "non-Federal tax business purpose," and (2) how an FCo that changes its AFS method should be treated. The Treasury Department and the IRS particularly solicit comments that would provide data, other evidence, or models that would enhance the rigor of evaluating FCos that change their AFS method, for purposes of developing the final regulations.

b. Cap on applicable insurance liabilities

Under the statute**,** a foreign corporation that does not prepare an AFS using US GAAP or IFRS may use an AFS prepared under local accounting rules to determine the amount of its applicable insurance liabilities. However, it is possible that local accounting rules in some foreign jurisdictions may permit reporting of insurance liabilities in a way that is economically unreasonable and inconsistent with the intent of the QIC rules. For example, US GAAP and IFRS both require discounting of insurance liabilities to determine the present value of an insurance company's liabilities. However, the Treasury Department and the IRS understand that local accounting rules in some foreign jurisdictions might not require discounting or might not adequately discount reserves (or other applicable insurance liabilities). This would make it easier for a foreign corporation that uses local accounting to qualify as a QIC. This could provide an incentive for U.S. investors to route their investment dollars through foreign corporations that otherwise would fail the QIC test, yielding a potential tax advantage to U.S. investors relative to other investments they might make, an outcome that is economically inefficient.

To address this issue, the proposed regulations provide that, if a foreign insurance company prepares its AFS under a local accounting standard that does not require discounting of unpaid losses and other loss reserves on an economically reasonable basis, for purposes of the QIC test, the company's AFS insurance liabilities must be reduced using US GAAP or IFRS discounting principles. Local accounting rules will otherwise continue to apply for determining amounts relevant to the QIC test. Applicable insurance liabilities may not exceed the discounted amount. As a point of reference, the discounting of unpaid losses is required by all domestic insurance companies that are taxed on their underwriting income or that file US GAAP-based financial statements.

The question of whether losses are discounted on an economically reasonable basis is determined under the relevant facts and circumstances. However, in order for losses to be discounted on an economically reasonable basis, discounting must be based on loss and claim payment patterns for either the foreign corporation or insurance companies in similar lines of insurance business. In addition, a discount rate based on these loss and claim payment patterns of at least the risk free rate in U.S. dollars or in a foreign currency in which the foreign corporation conducts some or all of its insurance business must be used. A loss discounting methodology consistent with that used for US GAAP or IFRS purposes will be considered reasonable for this purpose.

The Treasury Department and the IRS considered as alternatives (i) issuing no regulations to govern discounting of insurance losses for purposes of determining whether applicable insurance liabilities exceed the statutory cap, and (ii) capping the amount of applicable insurance liabilities at the amount that would be permitted to an insurance company subject to the insurance reserve calculation rules under Subchapter L of the Code.

Under the first approach, U.S. investors would have an incentive to seek out those corporations that do not file US GAAP or IFRS statements, an outcome that would provide an economically inefficient tax advantage to U.S. investors in those companies.

The second approach would be considerably more burdensome to a foreign corporation because, as a practical matter, it would require foreign corporations to apply complex U.S. tax rules with which they are likely not familiar. An excessive compliance burden on foreign corporations not subject to U.S. taxation would make it less likely that they would do the work necessary to enable their minority U.S. owners to determine if the corporation is a PFIC. Thus, this alternative was rejected because it could unduly inhibit U.S. investors from placing their funds in profitable foreign corporations that are legitimate active insurance companies, an economically desirable activity in light of the intents and purposes of the statute, relative to the proposed regulations.

The Treasury Department and the IRS do not have data available and models sensitive enough to estimate the additional volume of U.S. investment that might be drawn under this alternative approach to QICs that did not discount insurance losses in an economically reasonable manner, relative to the proposed regulations. The Treasury Department and the IRS also do not have data available and models sensitive enough to estimate the benefit that arises from the improved integrity of the tax system arising from the proposed regulations relative to not issuing such regulations. Further, the Treasury Department and the IRS do not have data available to estimate the additional accounting burden that would fall on FCos under the proposed regulations, relative to not issuing such regulations, a cost that would potentially be passed on to U.S. investors.

The Treasury Department and the IRS also do not have data available to estimate the increased loss to minority U.S. shareholders if the second alternative approach (capping liabilities to the amount that would be permitted under Subchapter L) were adopted.

The Treasury Department and the IRS solicit comments on all aspects of these proposed regulations and particularly solicit comments that would provide data, other evidence, or models that would enhance the rigor by which conditions on the cap on applicable insurance liabilities will be developed for the final regulations.

II. *Paperwork Reduction Act*

The collections of information in these proposed regulations are in proposed §1.1297-1(d)(1)(ii)(B), (d)(1)(iii)(B), and (d)(1)(iv), proposed §1.1297-4(d)(5)(i) and (iii), and proposed §1.1298-4(d)(2). The information in all of the collections of information provided will be used by the IRS for tax compliance purposes.

A. *Collections of information under existing tax forms*

The collections of information in proposed §1.1297-1(d)(1)(ii)(B), (d)(1)(iii)(B), and (d)(1)(iv) are required to be provided by taxpayers that make an election or revoke an election to use an alternative measuring period or adjusted bases to measure assets for purposes of the Asset Test with respect to a foreign corporation. These collections of information are satisfied by filing Form 8621 or attachments thereto. For purposes of the Paperwork Reduction Act, 44 U.S.C. 3501 et seq. ("PRA"), the reporting burden associated with the collection of information in the Form 8621 will be reflected in the Paperwork Reduction Act Submission associated with that form (OMB control number 1545-1002). If a Form 8621 is not required to be filed, the collections of information under proposed §1.1297-1(d)(1)(ii)(B), (d)(1)(iii)(B), and (d)(1)(iv) are satisfied by attaching a statement to the taxpayer's return. For purposes of the Paperwork Reduction Act, the reporting burden associated with these collections of information will be reflected in the Paperwork Reduction Act Submissions associated with Forms 990-PF and 990-T (OMB control number 1545-0047); Form 1040 (OMB control number 1545-0074); Form 1041 (OMB control number 1545-0092); Form 1065 (OMB control number 1545-0123); and Forms 1120, 1120-C, 1120-F, 1120-L, 1120-PC, 1120-REIT, 1120-RIC, and 1120-S (OMB control number 1545-0123).

The collection of information in proposed §1.1297-4(d)(5)(iii) is required to be provided by taxpayers that make an election under section 1297(f)(2). This collection of information is satisfied by filing Form 8621. For purposes of the Paperwork Reduction Act, the reporting burden associated with the collection of information in the Form 8621 will be reflected in the Paperwork Reduction Act Submission associated with Form 8621 (OMB control number 1545-1002).

The following table displays the number of respondents estimated to be required to report on Form 8621 or, in the case of individual filers, on attachments to Form 1040, as applicable, with respect to the collections of information in these regulations. Due to the absence of available tax data, estimates of respondents required to attach a statement to other types of tax returns, as applicable, are not available.

	Number of Respondents (Estimated)
Form 1040	35,000-45,000
Form 8621	50,000-55,000

Source: RAAS:CDW

The numbers of respondents in the table were estimated by the Research, Applied Analytics and Statistics Division ("RAAS") of the IRS from the Compliance Data Warehouse ("CDW").

Data for Form 1040 represents estimates of the total number of taxpayers that may attach a statement to their Form 1040 to make or revoke the elections in proposed §1.1297-1(d)(1)(ii)(B), (d)(1)(iii)(B), and (d)(1)(iv). The lower bound estimate reflects the CDW-based estimate of unique individual taxpayers filing Form 8621 between 2014 and 2017. The upper bound estimate reflects the CDW-based estimate of unique individual taxpayers that filed Form 8938 between 2016 and 2017 indicating that they owned an interest in a foreign partnership or corporation.[5] Accordingly, the difference between the lower bound and upper bound estimates reflects an estimate of the possible change in the number of respondents as a result of the changes made by the Act and the proposed regulations.

Data for Form 8621 represent estimates of the total number of taxpayers that may be required to file Form 8621. The lower bound estimate reflects the CDW-based estimate of unique taxpayers filing Form 8621 between 2014 and 2017. The upper bound estimate reflects an estimated 10 percent increase in the amount of taxpay-

[5] While PFICs are corporations, partnerships are included in our count given taxpayers may own an interest in a foreign corporation through a foreign partnership. More robust reporting on Form 8938 started in 2016 so we do not include prior years in our estimate.

ers that may file to make or revoke the elections in proposed §1.1297-1(d)(1)(ii)(B), (d)(1)(iii)(B), and (d)(1)(iv) and proposed §1.1297-4(d)(5)(iii). Accordingly, the difference between the lower bound and upper bound estimates reflect an estimate of the possible change in the number of respondents as a result of the changes made by the Act and the proposed regulations.

The current status of the PRA submissions related to the tax forms on which reporting under these regulations will be required is summarized in the following table. The burdens associated with the information collections in the forms are included in aggregated burden estimates for the OMB control numbers 1545-0047 (which represents a total estimated burden time for all forms and schedules for tax-exempt entities of 50.5 million hours and total estimated monetized costs of $3.59 billion ($2018)), 1545-0074 (which represents a total estimated burden time for all forms and schedules for individuals of 1.784 billion hours and total estimated monetized costs of $31.764 billion ($2017)), 1545-0092 (which represents a total estimated burden time for all forms and schedules for trusts and estates of 307.8 million hours and total estimated monetized costs of $9.95 billion ($2016)), and 1545-0123 (which represents a total estimated burden time for all forms and schedules for corporations of 3.157 billion hours and total estimated monetized costs of $58.148 billion ($2017)). The burden estimates provided in the OMB control numbers in the following table are aggregate amounts that relate to the entire package of forms associated with the OMB control number, and will in the future include, but not isolate, the estimated burden of only those information collections associated with these proposed regulations. These numbers are therefore unrelated to the future calculations needed to assess the burden imposed by these regulations. To guard against over-counting the burden that international tax provisions imposed prior to the Act, the Treasury Department and the IRS urge readers to recognize that these burden estimates have also been cited by regulations (such as the foreign tax credit regulations, 83 FR 63200) that rely on the applicable OMB control numbers in order to collect information from the applicable types of filers.

In 2018, the IRS released and invited comment on drafts of Forms 990-PF (Return of Private Foundation or Section 4947(a)(1) Trust Treated as Private Foundation), 990-T (Exempt Organization Business Income Tax Return), 1040 (U.S. Individual Income Tax Return), (U.S. Income Tax Return for Estates and Trusts), 1065 (U.S. Return of Partnership Income), 1120 (U.S. Corporation Income Tax Return), and 8621 (Return by a Shareholder of a Passive Foreign Investment Co. or Qualified Electing Fund). The IRS received comments only regarding Forms 1040, 1065, and 1120 during the comment period. After reviewing all such comments, the IRS made the forms available on December 21, 2018 for use by the public.

No burden estimates specific to the forms affected by the proposed regulations are currently available. The Treasury Department and the IRS have not estimated the burden, including that of any new information collections, related to the requirements under the proposed regulations. The Treasury Department and the IRS request comments on all aspects of information collection burdens related to the proposed regulations, including estimates for how much time it would take to comply with the paperwork burdens described above for each relevant form and ways for the IRS to minimize the paperwork burden. In addition, drafts of IRS forms are posted for public review at https://apps.irs.gov/app/picklist/list/draftTaxForms.htm. Comments on these forms can be submitted at https://www.irs.gov/forms-pubs/comment-on-tax-forms-and-publications. These forms will not be finalized until after they have been approved by OMB under the PRA.

Form	Type of Filer	OMB Number(s)	Status
Forms 990-PF, 990-T	Tax exempt entities (NEW Model)	1545-0047	Published 60-day Federal Register notice on 8/22/18.
	Link: https://www.federalregister.gov/documents/2018/08/22/2018-18135/proposed-collection-comment-request-for-forms-990-990-ez-sch-b-br-br-990-ez-sch-l-lp-990-ez-990-pf		
Form 1040	Individual (NEW Model)	1545-0074	Limited Scope submission (1040 only) approved on 12/7/18. Full ICR submission for all forms in 3/2019. 60 Day Federal Register notice not published yet for full collection.
	Link: https://www.reginfo.gov/public/do/PRAViewICR?ref_nbr=201808-1545-031		
Form 1041	Trusts and estates	1545-0092	Submitted to OMB for review on 9/27/18.
	Link: https://www.reginfo.gov/public/do/PRAViewICR?ref_nbr=201806-1545-014		
Form 1065	Business (NEW Model)	1545-0123	Published in the Federal Register on 10/11/18. Public Comment period closed on 12/10/18.
	Link: https://www.federalregister.gov/documents/2018/10/09/2018-21846/proposed-collection-comment-request-for-forms-1065-1065-b-1066-1120-1120-c-1120-f-1120-h-1120-nd		

<table>
<tr><th>Form</th><th>Type of Filer</th><th>OMB Number(s)</th><th>Status</th></tr>
<tr><td rowspan="2">Forms 1120, 1120-C, 1120-F, 1120-L, 1120-PC, 1120-REIT, 1120-RIC, 1120-S</td><td>Business (NEW Model)</td><td>1545-0123</td><td>Published in the Federal Register on 10/11/18. Public Comment period closed on 12/10/18.</td></tr>
<tr><td colspan="3">Link: https://www.federalregister.gov/documents/2018/10/09/2018-21846/proposed-collection-comment-request-for-forms-1065-1065-b-1066-1120-1120-c-1120-f-1120-h-1120-nd</td></tr>
<tr><td rowspan="2">Form 8621</td><td>Shareholders</td><td>1545-1001</td><td>Approved by OMB on 12/19/2018.</td></tr>
<tr><td colspan="3">Link: https://www.reginfo.gov/public/do/PRAViewICR?ref_nbr=201805-1545-007</td></tr>
</table>

B. *Collections of information generally not included on existing forms*

The collection of information in proposed §1.1298-4(d)(2) is required for a foreign corporation that relies on the rule in section 1298(b)(7) and proposed §1.1298-4(b)(1). This collection of information is satisfied by filing a statement attached to the foreign corporation's return. For purposes of the Paperwork Reduction Act, the reporting burden associated with this collection of information will be reflected in the Paperwork Reduction Act Submissions associated with Form 1120-F (OMB control number 1545-0123). The number of affected filers, burden estimates, and Paperwork Reduction Act status for this OMB control number are discussed in connection with the Form 1120 in Part II.A of the Special Analyses.

Alternatively, if a foreign corporation is not required to file a return, the collection of information in proposed §1.1298-4(d)(2) is satisfied by the foreign corporation's maintaining a statement in its records or including it in its public filings.

The collection of information in proposed §1.1297-4(d)(5)(i) is required for a foreign corporation for which a taxpayer makes an election under section 1297(f)(2). This collection of information is satisfied by a foreign corporation providing a statement to a shareholder.

The collection of information contained in proposed §1.1298-4(d)(2) (for foreign corporations that are not required to file Form 1120-F) and proposed §1.1297-4(d)(5)(i) will be submitted to the Office of Management and Budget in accordance with the Paperwork Reduction Act. Comments on the collections of information should be sent to the **Office of Management and Budget**, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, SE:W:CAR:MP:T:T:SP, Washington, DC 20224. Comments on the collection of information should be received by September 9, 2019.

Comments are specifically requested concerning:

Whether the proposed collection of information is necessary for the proper performance of the duties of the IRS, including whether the information will have practical utility;

The accuracy of the estimated burden associated with the proposed collection of information;

How the quality, utility, and clarity of the information to be collected may be enhanced;

How the burden of complying with the proposed collection of information may be minimized, including through the application of automated collection techniques or other forms of information technology; and

Estimates of capital or start-up costs and costs of operation, maintenance, and purchases of services to provide information for the collections discussed in Part II.B of this Special Analyses.

Estimated total annual reporting burden: 200 hours.

Estimated total annual monetized cost burden: $19,000.

Estimated average annual burden hours per respondent: one hour.

Estimated number of respondents: 200.

Estimated annual frequency of responses: once.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number assigned by the Office of Management and Budget.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

III. *Regulatory Flexibility Act*

Pursuant to the Regulatory Flexibility Act (5 U.S.C. chapter 6), it is hereby certified that the proposed regulations will not have a significant economic impact on a substantial number of small entities within the meaning of section 601(6) of the Regulatory Flexibility Act ("small entities").

The statutory provisions in sections 1291 through 1298 (the "PFIC regime") generally affect U.S. taxpayers that have ownership interests in foreign corporations that are not controlled foreign corporations ("CFCs"). The reporting burdens in proposed §1.1297-1(d)(1)(ii)(B), (d)(1)(iii)(B), and (d)(1)(iv) and proposed §1.1297-4(d)(5)(iii) generally affect the described U.S. taxpayers that elect to make or revoke certain elections related to the PFIC regime. The reporting burdens in proposed §1.1297-4(d)(5)(ii) and proposed §1.1298-4(d)(2) affect only foreign corporations. In general, foreign corporations are not considered small entities. Nor are U.S. taxpayers considered small entities to the extent the taxpayers are natural persons or entities other than small entities. Data estimating the number of filers for the PRA section indicate that individuals (Form 1040 filers) make up approximately 70 percent of those who report PFIC income while U.S. businesses of all sizes make up approximately 20 percent of Form 8621 filers. Most of these U.S. businesses are partnerships that do not pay entity level taxes. Accordingly, only small entities that have ownership interests in foreign corporations that are not CFCs and that wish to make or revoke an election pursuant to proposed §1.1297-1(d)(1)(ii)(B), (d)(1)(iii)(B), and (d)(1)(iv) and proposed §1.1297-4(d)(5)(iii) are affected by the proposed regulations.

The data to assess the number of small entities potentially affected by proposed §1.1297-1(d)(1)(ii)(B), (d)(1)(iii)(B), and (d)(1)(iv) and proposed §1.1297-4(d)(5)(iii) are not readily available.

Regardless of the number of small entities potentially affected by the proposed regulations, the Treasury Department and the IRS have concluded that there is no significant economic impact on such entities as a result of the proposed regulations.

Data on U.S. businesses that invest in a PFIC is limited. To get a sense of the magnitude of the taxes currently collected by businesses that invest in PFICs, the ratio of PFIC regime tax to (gross) total income was calculated for 2012 through 2017 for C corporations that filed the Form 8621. Total income was determined by matching each C corporation filing the Form 8621 to its Form 1120. Ordinary QEF income was assumed to be taxed at 37 percent while QEF capital gains and mark-to-market income was assumed to be taxed at the lower 20 percent capital gains rate. The section 1291 tax and interest charge tax were included as reported. Only those corporations where a match was found and that had positive total income were included in the analysis.[6] While the number was small, approximately 150 to 250 C corporations per year, the ratio of the tax to total income was less than 0.01 percent even when $100 million of the additional tax estimated by the Joint Committee on Taxation was included each year. Looking only at the approximately 50 to 150 C corporations per year with $25 million or less of total income resulted in the tax to total income percentage increasing to at most 1.39 percent in 2017.

	2012	2013	2014	2015	2016	2017
	($ millions)					
All C corporations						
Tax	99	108	118	126	110	121
Total Income	6,487,867	4,205,127	14,154,789	19,935,845	16,443,073	16,888,107
Tax to Total Income	0.002%	0.003%	0.001%	0.001%	0.001%	0.001%
C corporations with total income of $25 million or less						
Tax	*	*	*	3	3	5
Total Income	302	463	563	627	562	348
Tax to Total Income	0.039%	0.068%	0.008%	0.516%	0.524%	1.390%

Source: RAAS, CDW. * indicates less than $1 million.

Thus, even if the economic impact of the proposed regulations is interpreted broadly to include the tax liability due under the PFIC regime, which small entities would be required to pay even if the proposed regulations were not issued, the economic impact should not be regarded as significant under the Regulatory Flexibility Act.

Additionally, the economic impact of the proposed regulations when considered alone should be minimal. Any economic impact of the final regulations stems from the collection of information requirements imposed by proposed §1.1297-1(d)(1)(ii)(B), (d)(1)(iii)(B), and (d)(1)(iv) and proposed §1.1297-4(d)(5)(iii). The Treasury Department and the IRS have determined that the average burden is 1 hour per response. The IRS's Research, Applied Analytics, and Statistics division estimates that the appropriate wage rate for this set of taxpayers is $95 per hour. Thus, the annual burden per taxpayer from the collection of information requirement is $95. Furthermore, these requirements apply only if a taxpayer chooses to make an election or rely on a favorable rule.

Accordingly, it is hereby certified that the proposed rule would not have a significant economic impact on a substantial number of small entities. Notwithstanding this certification, the Treasury Department and the IRS invite comments from the public on both the number of entities affected (including whether specific industries are affected) and the economic impact of this proposed rule on small entities.

Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking has been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small businesses.

IV. *Unfunded Mandates Reform Act*

Section 202 of the Unfunded Mandates Reform Act of 1995 (UMRA) requires that agencies assess anticipated costs and benefits and take certain other actions be-

[6] To be conservative, C corporations reporting more than $6 billion of total income are excluded since we suspect these amounts are improperly reported.

fore issuing a final rule that includes any Federal mandate that may result in expenditures in any one year by a state, local, or tribal government, in the aggregate, or by the private sector, of $100 million in 1995 dollars, updated annually for inflation. In 2018, that threshold is approximately $150 million. This rule does not include any Federal mandate that may result in expenditures by state, local, or tribal governments, or by the private sector in excess of that threshold.

V. *Executive Order 13132: Federalism*

Executive Order 13132 (entitled "Federalism") prohibits an agency from publishing any rule that has federalism implications if the rule either imposes substantial, direct compliance costs on state and local governments, and is not required by statute, or preempts state law, unless the agency meets the consultation and funding requirements of section 6 of the Executive Order. This proposed rule does not have federalism implications and does not impose substantial direct compliance costs on state and local governments or preempt state law within the meaning of the Executive Order.

Comments and Requests for a Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any comments that are timely submitted to the IRS as prescribed in this preamble under the "Addresses" heading. The Treasury Department and the IRS specifically request comments on all aspects of the proposed rules. All comments will be available for public inspection and copying at www.regulations.gov or upon request. A public hearing will be scheduled if requested in writing by any person that timely submits written comments. If a public hearing is scheduled, notice of the date, time and place for the public hearing will be published in the **Federal Register**.

Statement of Availability of IRS Documents

IRS Revenue Procedures, Revenue Rulings, notices, and other guidance cited in this document are published in the Internal Revenue Bulletin (or Cumulative Bulletin) and are available from the Superintendent of Documents, U.S. Government Printing Office, Washington, DC 20402, or by visiting the IRS website at *www.irs.gov*.

Drafting Information

The principal drafters of these regulations are Josephine Firehock, Rose E. Jenkins, and Jorge M. Oben of the Office of Associate Chief Counsel (International). Other personnel from the Treasury Department and the IRS also participated in the development of these regulations.

Withdrawal of Proposed Regulations

Accordingly, under the authority of 26 U.S.C. 7805, the notice of proposed rulemaking (REG-108214-15) that was published in the **Federal Register** on April 24, 2015, (80 FR 50814) is withdrawn.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding entries for §§ 1.1297-1, 1.1297-2, 1.1297-4, 1.1298-2, and 1.1298-4 in numerical order to read in part as follows:

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

Section 1.1297-1 also issued under 26 U.S.C. 1298(g).

Section 1.1297-2 also issued under 26 U.S.C. 1298(g).

* * * * *

Section 1.1297-4 also issued under 26 U.S.C. 1297(b)(2)(B) and 1298(g).

* * * * *

Section 1.1298-2 also issued under 26 U.S.C. 1298(b)(3) and (g).

Section 1.1298-4 also issued under 26 U.S.C. 1298(g).

* * * * *

Par. 2. Section 1.1291-0 is amended by revising the heading for §1.1291-1 and adding entries for §1.1291-1(b)(8)(iv)(A) and (B), (b)(8)(iv)(B)(*1*) and (*2*), (b)(8)(iv)(C), and (b)(8)(iv)(C)(*1*) and (*2*) to read as follows:

§1.1291-0 Treatment of shareholders of certain passive foreign investment companies; table of contents.

* * * * *

§1.1291-1 Taxation of United States persons that indirectly own PFIC stock.

* * * * *

(b) * * *

(8) * * *

(iv) * * *

(A) Example 1.

(B) Example 2.

(*1*) Facts.

(*2*) Results.

(C) Example 3.

(*1*) Facts.

(*2*) Results.

* * * * *

Par. 3. Section 1.1291-1 is amended by:

1. Revising the section heading.
2. Revising the second sentence of paragraph (b)(8)(ii)(B).
3. Revising paragraphs (b)(8)(iii)(A), (B), and (C).
4. Designating *Example 1* in paragraph (b)(8)(iv) as paragraph (b)(8)(iv)(A).
5. Adding paragraphs (b)(8)(iv)(B) and (C).
6. Revising paragraph (j)(3).
7. Adding paragraph (j)(4).

The revision and additions read as follows:

§1.1291-1 Taxation of United States persons that indirectly own PFIC stock.

* * * * *

(b) * * *

(8) * * *

(ii) * * *

(B) * * * Sections 1297(d) and 1298(b)(7) and §1.1297-4(b)(2) and (f)(2) do not apply in determining whether a foreign corporation is a PFIC for purposes of this paragraph (b)(8)(ii)(B).

* * * * *

(iii) *Ownership through pass-through entities*—(A) *Partnerships*. Except as otherwise provided in this paragraph (b)(8)(iii)(A), if a foreign or domestic partnership directly or indirectly owns stock, the partners of the partnership are considered to own such stock proportionately in accordance with their ownership interests in the partnership. Solely for purposes of determining whether a person satisfies the ownership threshold described in paragraph (b)(8)(ii)(A) of this section with respect to a foreign corporation that is not a PFIC (determined without applying sections 1297(d) and 1298(b)(7)), the first sentence of this paragraph (b)(8)(iii)(A) applies only in the case of a partner that owns 50 percent or more of the ownership interests in the partnership that directly or indirectly owns the stock of the foreign corporation.

(B) *S Corporations*. Except as otherwise provided in this paragraph (b)(8)(iii)(B), if an S corporation directly or indirectly owns stock, each S corporation shareholder is considered to own such stock proportionately in accordance with the shareholder's ownership interest in the S corporation. Solely for purposes of determining whether a person satisfies the ownership threshold described in paragraph (b)(8)(ii)(A) of this section with respect to a foreign corporation that is not a PFIC (determined without applying sections 1297(d) and 1298(b)(7)), the first sentence of this paragraph (b)(8)(iii)(B) applies only in the case of a S corporation shareholder that owns 50 percent or more of the ownership interests in the S corporation that directly or indirectly owns the stock of the foreign corporation.

(C) *Estates and nongrantor trusts*. Except as otherwise provided in this paragraph (b)(8)(iii)(C), if a foreign or domestic estate or nongrantor trust (other than an employees' trust described in section 401(a) that is exempt from tax under section 501(a)) directly or indirectly owns stock, each beneficiary of the estate or trust is considered to own a proportionate amount of such stock. For purposes of this paragraph (b)(8)(iii)(C), a nongrantor trust is any trust or portion of a trust that is not treated as owned by one or more persons under sections 671 through 679. Solely for purposes of determining whether a person satisfies the ownership threshold described in paragraph (b)(8)(ii)(A) of this section with respect to a foreign corporation that is not a PFIC (determined without applying sections 1297(d) and 1298(b)(7)), the first sentence of this paragraph (b)(8)(iii)(C) applies only in the case of a beneficiary whose proportionate share of the estate or trust that directly or indirectly owns the stock of the foreign corporation is 50 percent or more.

* * * * *

(iv) * * *

(B) *Example 2*—(*1*) *Facts*. A, a United States citizen, owns 50% of the interests in Foreign Partnership, a foreign partnership, the remaining interests in which are owned by an unrelated foreign person. Foreign Partnership owns 100% of the stock of FC1 and 50% of the stock of FC2, the remainder of which is owned by an unrelated foreign person. Both FC1 and FC2 are foreign corporations that are not PFICs (determined without applying sections 1297(d) and 1298(b)(7)). FC1 and FC2 each own 50% of the stock of FC3, a foreign corporation that is a PFIC.

(*2*) *Results*. Under paragraph (b)(8)(iii)(A) of this section, for purposes of determining whether A is a shareholder of FC3, A is considered to own 50% (50%x100%), or 50% or more, of FC1, because A owns 50% or more of Foreign Partnership, but 25% (50%x50%) of FC2. Thus, under paragraph (b)(8) of this section, A is considered to own 25% of the stock of FC3 (50%x100%x50%) indirectly through FC1, and thus is a shareholder of FC3 for purposes of the PFIC provisions, but is not considered to own any stock of FC3 indirectly through FC2.

(C) *Example 3*—(*1*) *Facts*. The facts are the same as in paragraph (b)(8)(iv)(B)(*1*) of this section (the facts in *Example 2*), except that A owns 40% of the interests in Foreign Partnership.

(*2*) *Results*. Under paragraph (b)(8)(iii)(A) of this section, for purposes of determining whether A is a shareholder of FC3, A is not considered to own 50% or more of FC1 or FC2 because it does not own 50% or more of the interests in Foreign Partnership. Thus, under paragraph (b)(8) of this section, A is not considered to own any stock of FC3 indirectly through FC1 or FC2.

* * * * *

(j) * * *

(3) Except as otherwise provided in paragraph (j)(4) of this section, paragraphs (b)(2)(ii) and (v), (b)(7) and (8), and (e)(2) of this section apply to taxable years of shareholders ending on or after December 31, 2013.

(4) Paragraphs (b)(8)(ii)(B), (b)(8)(iii)(A), (B), and (C), and (b)(8)(iv)(B) and (C) of this section apply to taxable years of shareholders beginning on or after the date of publication of a Treasury decision adopting these rules as final regulations in the **Federal Register**.

Par. 4. Section 1.1297-0 is amended by revising the introductory text and adding entries for §§1.1297-1, 1.1297-2, and 1.1297-4 in numerical order to read as follows:

§1.1297-0 Table of contents.

This section contains a listing of the headings for §§1.1297-1, 1.1297-2, 1.1297-3, 1.1297-4, and 1.1297-5.

(ii) Special rule when only part of an asset produces income.
(iii) Special rule for stock that produced income that was excluded from passive income under section 1297(b)(2)(C).
(iv) Example.
(A) Facts.
(B) Results.
(3) Partnership interest.
(i) Look-through partnership.
(ii) Less-than-25-percent-owned partnership.
(4) Dealer property.
(e) Stapled stock.
(f) Definitions.
(1) Look-through partnership.
(2) Measuring date.
(3) Measuring period.
(4) Non-passive asset.
(5) Non-passive income.
(6) Passive asset.
(7) Passive income.
(8) Tested foreign corporation.
(g) Applicability date.
(1) [Reserved]
(2) In general.
§1.1297-2 Special rules regarding look-through subsidiaries.
(a) Overview.
(b) General rules.
(1) Tested foreign corporation's ownership of a corporation.
(2) Tested foreign corporation's proportionate share of the assets and income of a look-through subsidiary.
(i) Proportionate share of assets.
(ii) Proportionate share of income.
(A) General rule.
(B) Special rule.
(iii) Coordination of section 1297(c) with section 1298(b)(7).
(3) Examples.
(i) Example 1.
(A) Facts.
(B) Results.
(ii) Example 2.
(A) Facts.
(B) Results.
(iii) Example 3.
(A) Facts.
(B) Results.
(c) Elimination of certain intercompany assets and income.
(1) General rule for asset test.
(2) General rule for income test.
(3) Partnerships.
(4) Examples.
(i) Example 1.
(A) Facts.
(B) Results.
(ii) Example 2.
(A) Facts.
(B) Results.
(iii) Example 3.
(A) Facts.
(B) Results.
(d) Related person determination for purposes of section 1297(b)(2)(C).
(1) General rule.
(2) Example.
(i) Facts.
(ii) Results.
(e) Treatment of activities of certain look-through subsidiaries and look-through partnerships for purposes of section 954(c)(2)(A) active rents and royalties exception.
(1) General rule.
(2) Examples.
(i) Example 1.
(A) Facts.
(B) Results.
(ii) Example 2.
(A) Facts.
(B) Results.
(f) Gain on disposition of stock in a look-through subsidiary.
(1) Amount of gain taken into account.
(2) Characterization of residual gain as passive income.
(3) Examples.
(i) Example 1.
(A) Facts.
(B) Results.
(ii) Example 2.
(A) Facts.
(B) Results.
(iii) Example 3.
(A) Facts.
(B) Results.
(g) Definitions.
(1) Look-through subsidiary.
(2) LTS debt.
(3) LTS stock.
(4) Residual gain.
(5) Unremitted earnings.
(h) Applicability date.
* * * * *
§1.1297-4 Qualifying insurance corporation.
(a) Scope.
(b) Qualifying insurance corporation.
(c) 25 percent test.
(d) Election to apply the alternative facts and circumstances test.
(1) In general.
(2) Predominantly engaged in an insurance business.
(i) In general.
(ii) Facts and circumstances.
(iii) Examples of facts indicating a foreign corporation is not predominantly engaged in an insurance business.
(3) Runoff-related circumstances.
(4) Rating-related circumstances.
(5) Election.
(i) In general.
(ii) Information provided by foreign corporation.
(iii) Time and manner for making the election.
(e) Rules limiting the amount of applicable insurance liabilities.
(1) In general.
(2) General limitation on applicable insurance liabilities.
(3) Additional limitation on amount of applicable insurance liabilities for a foreign corporation that does not prepare a financial statement based on a financial reporting standard.
(i) In general.
(ii) Choice of accounting method.
(4) Changes to financial statements prepared.
(f) Definitions.
(1) Applicable financial statement.
(2) Applicable insurance liabilities.
(3) Applicable insurance regulatory body.
(4) Financial reporting standard.
(5) Generally accepted accounting principles or GAAP.
(6) Insurance business.
(7) Total assets.
(g) Applicability date.
§1.1297-5 Exception from the definition of passive income for active insurance income.
(a) Scope.
(b) Exclusion from passive income of active insurance income.
(c) Income derived by a QIC in the active conduct of an insurance business.
(1) In general.
(2) Insurance business.
(3) Active conduct of an insurance business.
(i) In general.
(ii) Control test.

(A) Ownership.

(*1*) Ownership by or of a corporation.

(*2*) Ownership of a partnership.

(B) Control and supervision.

(C) Compensation.

(4) Active conduct percentage.

(i) In general.

(ii) Related expense determination.

(iii) Ceding commission.

(d) Income of qualifying domestic insurance corporation.

(e) Exclusion of assets for purposes of the passive asset test under section 1297(a)(2).

(f) Treatment of income and assets of certain look-through subsidiaries and look-through partnerships for purposes of the section 1297(b)(2)(B) exception.

(1) General rule.

(2) Applicable statement for tested foreign corporations applying paragraph (g)(1) of this section.

(g) No double counting.

(h) Definitions.

(1) Insurance services.

(2) Investment activity.

(3) Qualifying insurance corporation or QIC.

(i) Applicability date.

Par. 5. Sections 1.1297-1 and 1.1297-2 are added to read as follows:

*§1.1297-1 Definition of passive foreign investment company***.**

(a) *Overview*. This section provides rules concerning the income test set forth in section 1297(a)(1) and the asset test set forth in section 1297(a)(2). Paragraph (b) of this section provides a rule relating to the definition of gross income for purposes of section 1297. Paragraph (c) of this section sets forth rules relating to the definition of passive income for purposes of section 1297. Paragraph (d) of this section provides rules relating to the asset test of section 1297. See §§1.1297-2 and 1.1298-4 for additional rules concerning the treatment of the income and assets of a corporation subject to look-through treatment under section 1297(c). Paragraph (e) of this section sets forth rules relating to the determination of passive foreign investment company (PFIC) status for stapled entities. Paragraph (f) of this section sets forth definitions applicable for this section, and paragraph (g) of this section sets forth the applicability date of this section.

(b) *Dividends included in gross income*—(1) *General rule*. For purposes of section 1297, gross income includes dividends that are excluded from gross income under section 1502 and §1.1502-13.

(2) *Example*—(i) *Facts*. USP is a domestic corporation that owns 30% of TFC, a foreign corporation. The remaining 70% of TFC is owned by FP, a foreign corporation that is unrelated to USP. TFC owns 25% of the value of USS1, a domestic corporation. USS1 owns 80% of the value of USS2, a domestic corporation. USS1 and USS2 are members of an affiliated group (as defined in section 1504(a)) filing a consolidated return. USS2 distributes a dividend to USS1 that is excluded from USS1's income pursuant to §1.1502-13 for purposes of determining the U.S. Federal income tax liability of the affiliated group of which USS1 and USS2 are members.

(ii) *Results*. Although the dividend received by USS1 from USS2 is excluded from USS1's income for purposes of determining the U.S. Federal income tax liability of the affiliated group of which USS1 and USS2 are members, pursuant to paragraph (b)(1) of this section, for purposes of section 1297, USS1's gross income includes the USS2 dividend. Accordingly, for purposes of section 1297, TFC's gross income includes 25% of the dividend received by USS1 from USS2 pursuant to section 1297(c) and §1.1297-2(b)(2)(ii). See section 1298(b)(7) and §1.1298-4 for rules concerning the characterization of the USS2 dividend.

(c) *Passive income*—(1) *Foreign personal holding company income*—(i) *General rule*. For purposes of section 1297, except as otherwise provided in section 1297(b)(2), this section, and §1.1297-4, the term passive income means income of a kind that would be foreign personal holding company income as defined under section 954(c)(1). For the purpose of this paragraph (c)(1)—

(A) The exceptions to foreign personal holding company income in section 954(c)(1), 954(c)(2)(A) (relating to active rents and royalties), 954(c)(2)(B) (relating to export financing income), 954(c)(2)(C) (relating to dealers), and 954(h) (relating to entities engaged in the active conduct of a banking, financing, or similar business) are taken into account;

(B) The exceptions in section 954(c)(3) (relating to certain income received from related persons), 954(c)(6) (relating to certain amounts received from related controlled foreign corporations), and 954(i) (relating to entities engaged in the active conduct of an insurance business) are not taken into account;

(C) The rules in section 954(c)(4) (relating to sales of certain partnership interests) and 954(c)(5) (relating to certain commodity hedging transactions) are taken into account; and

(D) An entity is treated as a controlled foreign corporation within the meaning of section 957(a) for purposes of applying an exception to foreign personal holding company income in section 954(c) and (h) and for purposes of identifying whether a person is a related person with respect to such entity within the meaning of section 954(d)(3).

(ii) *Determination of gross income on a net basis for certain items of foreign personal holding company income*. For purposes of section 1297, the excess of gains over losses from property transactions described in section 954(c)(1)(B), the excess of gains over losses from transactions in commodities described in section 954(c)(1)(C), the excess of foreign currency gains over foreign currency losses described in section 954(c)(1)(D), and positive net income from notional principal contracts described in section 954(c)(1)(F) are taken into account as gross income. The excess of gains over losses and positive net income is calculated separately with respect to the tested foreign corporation and each look-through subsidiary (as defined in §1.1297-2(g)(1)).

(iii) *Dividends*. For purposes of section 1297, the term dividend includes all amounts treated as dividends for purposes of this chapter, including amounts treated as dividends pursuant to sections 302, 304, 356(a)(2), 964(e), and 1248.

(2) *Treatment of share of partnership income*—(i) *Look-through partnership*. A tested foreign corporation is treated as if it received directly its share of any item of income of a look-through partnership, and the exceptions to passive income in section 1297(b)(2) and the relevant exceptions to foreign personal holding company income in section 954(c) and (h) that are based on whether income is derived in the active conduct of a business or whether a corporation is engaged in the active conduct of a business apply to such income only if the exception would have applied to exclude the income from passive income or foreign personal holding company in the hands of the partnership, determined by taking into account only the activities of the partnership. See §1.1297-2(e) for rules that allow the activities of certain other entities to be taken into account for pur-

poses of determining the characterization of a tested foreign corporation's share of partnership income. See also §1.1297-2(d) for rules determining whether a person is a related person for purposes of applying section 1297(b)(2)(C) in the case of income received or accrued by a partnership that is treated as received directly by a tested foreign corporation pursuant to this paragraph (c)(2).

(ii) *Less-than-25-percent-owned partnership*. For purposes of section 1297, a tested foreign corporation's share of any item of income of a partnership in which the corporation owns, directly or indirectly, less than 25 percent of the value is treated as passive income.

(3) *Exception for certain interest, dividends, rents, and royalties received from a related person*—(i) *Allocation of interest*. For purposes of section 1297(b)(2)(C), interest that is received or accrued, as applicable based on the recipient's method of accounting, from a related person (as defined in section 1297(b)) is allocated to income of the related person that is not passive income in proportion to the ratio of the portion of the related person's non-passive income for its taxable year to the total amount of the related person's income for the taxable year that ends with or within the taxable year of the recipient.

(ii) *Allocation of dividends*. For purposes of section 1297(b)(2)(C), dividends that are received or accrued, as applicable based on the recipient's method of accounting, from a related person are allocated to income of the related person that is not passive income based on the relative portion of the related person's current earnings and profits for its taxable year that ends with or within the taxable year of the recipient that are attributable to non-passive income.

(iii) *Allocation of rents and royalties*. For purposes of section 1297(b)(2)(C), rents and royalties that are received or accrued, as applicable based on the recipient's method of accounting, from a related person are allocated to income of the related person that is not passive income to the extent the related person's deduction for the rent or royalty is allocated to non-passive income of the related person under the principles of §§1.861-8 through 1.861-14T.

(iv) *Determination of whether amounts are received or accrued from a related person*. For purposes of section 1297(b)(2)(C), the determination of whether interest, dividends, rents, and royalties were received or accrued from a related person is made on the date of the receipt or accrual, as applicable based on the recipient's method of accounting, of the interest, dividend, rent, or royalty.

(d) *Asset test*—(1) *Calculation of average annual value (or adjusted bases)*—(i) *General rule*. For purposes of section 1297, the calculation of the average percentage of assets held by a tested foreign corporation during its taxable year that produce passive income or that are held for the production of passive income is determined based on the average of the fair market values (or the average of the adjusted bases) of the passive assets and total assets held by the foreign corporation on the last day of each measuring period (*measuring date*) of the foreign corporation's taxable year. The average of the fair market values (or the average of the adjusted bases) of the foreign corporation's passive assets or total assets for the taxable year is equal to the sum of the values (or adjusted bases) of the passive assets or total assets, as applicable, on each measuring date of the foreign corporation's taxable year, divided by the number of measuring dates in the taxable year.

(ii) *Measuring period*—(A) *General rule*. Except as otherwise provided in paragraph (d)(1)(ii)(B) of this section, the measuring periods for a tested foreign corporation are the four quarters that make up the foreign corporation's taxable year.

(B) *Election to use alternative measuring period*. The average percentage of assets held by a tested foreign corporation during its taxable year that produce passive income or that are held for the production of passive income may be calculated using a period that is shorter than a quarter (such as a week or month). The same period must be used to measure the assets of the foreign corporation for the first year (including a short taxable year) that this alternative measuring period is used, and for any and all subsequent years, unless a revocation is made. An election to use an alternative measuring period or a revocation of such an election must be made in accordance with the rules of paragraph (d)(1)(iv) of this section.

(C) *Short taxable year*. For purposes of applying section 1297 to a tested foreign corporation that has a taxable year of less than twelve months (short taxable year), the average values (or adjusted bases) are determined based on the measuring dates of the foreign corporation's taxable year (determined as if the taxable year were not a short taxable year), and by treating the last day of the short taxable year as a measuring date.

(iii) *Adjusted basis*. (A) [Reserved]

(B) *Election*. An election under section 1297(e)(2)(B) with respect to an eligible tested foreign corporation or a revocation of such an election must be made in accordance with the rules of paragraph (d)(1)(iv) of this section.

(iv) *Time and manner of elections and revocations*—(A) *Elections*. An owner (as defined in this paragraph (d)(1)(iv)) of a foreign corporation makes an election described in paragraph (d)(1)(ii)(B) or (d)(1)(iii)(B) of this section for a taxable year in the manner provided in the Instructions to Form 8621 (or successor form), if the owner is required to file a Form 8621 (or successor form) with respect to the foreign corporation for the taxable year of the owner in which or with which the taxable year of the foreign corporation for which the election is made ends. If the owner is not required to file Form 8621 (or successor form) with respect to the foreign corporation for the taxable year, the owner makes such an election by filing a written statement providing for the election and attaching the statement to an original or amended Federal income tax return for the taxable year of the owner in which or with which the taxable year of the foreign corporation for which the election is made ends clearly indicating that such election has been made. An election can be made by an owner only if the owner's taxable year for which the election is made, and all taxable years that are affected by the election, are not closed by the period of limitations on assessments under section 6501. Elections described in in paragraphs (d)(1)(ii)(B) and (d)(1)(iii)(B) of this section are not eligible for relief under §301.9100-3 of this chapter. For purposes of this paragraph (d)(1)(iv), an owner of a foreign corporation is a United States person that is eligible under §1.1295-1(d) to make a section 1295 election with respect to the foreign corporation, or would be eligible under §1.1295-1(d) to make a section 1295 election if the foreign corporation were a PFIC.

(B) *Revocations and subsequent elections*. An election described in paragraph (d)(1)(ii)(B) or (d)(1)(iii)(B) of this section made pursuant to paragraph (d)(1)(iv)(A) of this section is effective for the taxable year of the foreign corporation for which it is made and all subsequent taxable years of such corporation unless revoked by the Commissioner or the owner (as defined in paragraph (d)(1)(iv)(A) of this section) of the foreign corporation. The owner of a foreign corporation may revoke such an election at any time. If an election described in paragraph (d)(1)(ii)(B) or (d)(1)(iii)(B) of this section has been revoked under this paragraph (d)(1)(iv)(B), a new election described in paragraph (d)(1)(ii)(B) or (d)(1)(iii)(B) of this section, as applicable, cannot be made until the sixth taxable year following the year for which the previous such election was revoked, and such subsequent election cannot be revoked until the sixth taxable year following the year for which the subsequent election was made. The owner revokes the election for a taxable year in the manner provided in the Instructions to Form 8621 (or successor form), if the owner is required to file a Form 8621 (or successor form) with respect to the foreign corporation for the taxable year of the owner in which or with which the taxable year of the foreign corporation for which the election is revoked ends, or by filing a written statement providing for the revocation and attaching the statement to an original or amended Federal income tax return for the taxable year of the owner in which or with which the taxable year of the foreign corporation for which the election is revoked ends clearly indicating that such election has been revoked, if the owner is not required to file Form 8621 (or successor form) with respect to the foreign corporation for the taxable year.

(v) *Change in method of measuring assets*—(A) *General rule*. For purposes of section 1297, when stock of a foreign corporation is not publicly traded for an entire taxable year, the assets of the foreign corporation must be measured for all measuring periods of the taxable year on the basis of value if the corporation was publicly traded on the majority of days during the year or section 1297(e)(2) did not otherwise apply to the corporation on the majority of days of the year, and on the basis of adjusted basis otherwise.

(B) *Example*. The following example illustrates the application of this paragraph (d)(1)(v).

(*1*) *Facts*. TFC is a controlled foreign corporation, 90% of the stock of which is wholly owned by USP at the beginning of its taxable year ending December 31 and throughout the year. The remaining 10% of its stock has historically been regularly traded on a national securities exchange that is registered with the Securities and Exchange Commission and continues to be until September 1 of the taxable year, when USP acquires all of it pursuant to a tender offer.

(*2*) *Results*. Because TFC was publicly traded on the majority of days during the year, the assets of the foreign corporation must be measured for all measuring periods of the taxable year on the basis of value.

(2) *Dual-character assets*—(i) *General rule*. Except as otherwise provided in paragraph (d)(2)(ii) of this section, for purposes of section 1297, an asset (or portion of an asset) that produces both passive income and non-passive income during a taxable year (dual-character asset) is treated as two assets for each measuring period in the taxable year, one of which is a passive asset and one of which is a non-passive asset. The value (or adjusted basis) of the dual-character asset is allocated between the passive asset and the non-passive asset in proportion to the relative amounts of passive income and non-passive income produced by the asset (or portion of an asset) during the taxable year. See paragraph (d)(2)(iii) of this section for a special rule concerning stock that has previously produced dividends subject to the exception provided in section 1297(b)(2)(C).

(ii) *Special rule when only part of an asset produces income*. For purposes of section 1297, when only a portion of an asset produces income during a taxable year, the asset is treated as two assets, one of which is characterized as a passive asset or a non-passive asset based on the income that it produces, and one of which is characterized based on the income that it is held to produce. The value (or adjusted basis) of the asset is allocated between the two assets pursuant to the method that most reasonably reflects the uses of the property. In the case of real property, an allocation based on the physical use of the property generally is the most reasonable method.

(iii) *Special rule for stock that produced income that was excluded from passive income under section 1297(b)(2)(C)*. Stock with respect to which no dividends are accrued or received, as applicable based on the recipient's method of accounting, during a taxable year but with respect to which dividends accrued or received, as applicable based on the recipient's method of accounting, during a prior taxable year were in whole or in part excluded from passive income under section 1297(b)(2)(C) and paragraph (c)(3)(ii) of this section is treated as two assets, one of which is a passive asset and one of which is a non-passive asset. The value (or adjusted basis) of the asset is allocated between the two assets in proportion to the average percentage of dividends that were characterized as passive income, and the average percentage of dividends characterized as non-passive income, for the previous two taxable years pursuant to section 1297(b)(2)(C) and paragraph (c)(3)(ii) of this section.

(iv) *Example*. The following example illustrates the application of this paragraph (d)(2).

(A) *Facts*. (*1*) USP is a domestic corporation that owns 30% of TFC, a foreign corporation. The remaining 70% of TFC is owned by FP, a foreign corporation that is unrelated to USP. TFC owns 20% of the value of FS1, a foreign corporation, and FP owns the remaining 80% of the value of FS1. FP, TFC, and FS1 are not controlled foreign corporations within the meaning of section 957(a), and each has a calendar year taxable year. For purposes of section 1297(b)(2)(C), FP is a "related person" with respect to TFC because FP owns more than 50% of the vote or value of TFC, and FS1 is a "related person" with respect to TFC because FP owns more than 50% of the vote or value of both TFC and of FS1.

(*2*) During Year 3, FP has only passive income, and FS1 has passive income of $200x and non-passive income of $800x. FS1 does not pay dividends during Year 3, but did pay $100x of dividends in Year 2 and $300x of dividends in Year 1. In Year 2, FS1 had current earnings and profits of $1000x, attributable to passive income of $100x and non-passive income of $900x; and, in Year 1, FS1 had current earnings and profits of $1000x, attributable to passive income of $500x and non-passive income of $500x. Throughout Year 3, TFC holds an obligation of FS1 with respect to which FS1 pays $100x of interest.

(*3*) In addition to the stock in FS1 and the FS1 obligation, TFC holds an office building, 40% of which is rented to FP throughout Year 3 for $100x per quarter. For the first two quarters of Year 3, 60% of the office building is used by TFC in a trade or business generating non-passive income. For the last two quarters of Year 3, 60% of the office building is rented to an unrelated person for $300x per quarter, and TFC's own officers or staff of employees regularly perform active and substantial management and operational functions while the property is leased.

(B) *Results*. (*1*) Under paragraph (c)(3)(ii) of this section, the dividends paid by FS1 in Year 2 were characterized as 10% passive income and 90% non-passive income. Under paragraph (c)(3)(ii) of this section, the dividends paid by FS1 in Year 1 were characterized as 50% passive income and 50% non-passive income. Accordingly, the average percentage of dividends for the previous two taxable years that were characterized as passive income is 40% (((10% x $100x) + (50% x $300x))/($100x + $300x)), and the average percentage of dividends characterized as non-passive income is 60% (((90% x $100x) + (50% x $300x))/($100x + $300x)). Thus, under paragraph (d)(2)(iii) of this section, 60% of each share of stock of FS1 is characterized as a non-passive asset and 40% is characterized as a passive asset for each quarter of Year 3 for purposes of applying section 1297(a)(2) to determine whether TFC is a PFIC.

(*2*) Under paragraph (c)(3)(i) of this section, the interest received by TFC from FS1 is characterized as 20% ($200x/($200x+$800x)) passive income and thus 80% non-passive income for purposes of applying section 1297(a)(1) to determine whether TFC is a PFIC. Accordingly, under paragraph (d)(2)(i) of this section, 20% of the obligation of FS1 is characterized as a passive asset and 80% as a non-passive asset for each quarter of Year 3 for purposes of applying section 1297(a)(2) to determine whether TFC is a PFIC.

(*3*) Under paragraph (c)(3)(iii) of this section, the rent received from FP throughout Year 3 is characterized as 100% passive income. Under paragraph (c)(1)(i)(A) of this section and section 954(c)(2)(A), the rent received from the unrelated person during the last two quarters is characterized as 100% non-passive income. Accordingly, under paragraph (d)(2)(i) of this section, 40% (($100x x 4)/(($100x x 4)+($300x x 2))) of the office building is a passive asset, and 60% (($300x x 2)/(($100x x 4)+($300x x 2))) is a non-passive asset for purposes of applying section 1297(a)(2) to determine whether TFC is a PFIC. Paragraph (d)(2)(ii) of this section does not apply because both portions of the office building generate income during Year 3.

(3) *Partnership interest*—(i) *Look-through partnership*. A tested foreign corporation is treated as holding directly its proportionate share of the assets held by a look-through partnership. The rules and principles of sections 701 through 761 apply to determine the corporate partner's proportionate share of the value of the partnership assets, as well as the proportionate share of the partnership's adjusted basis in the partnership's assets (taking into account any adjustments to such basis with respect to such partner under section 743). A tested foreign corporation's proportionate share of a partnership asset is treated as producing passive income, or being held to produce passive income, to the extent the asset produced, or was held to produce, passive income in the hands of the partnership under the rules in paragraph (c)(2) of this section.

(ii) *Less-than-25-percent-owned partnership*. For purposes of section 1297, a tested foreign corporation's interest in a partnership in which the corporation owns, directly or indirectly, less than 25 percent of the value is treated as a passive asset.

(4) *Dealer property*. For purposes of section 1297(a)(2), an asset that produces, or would produce upon disposition, income or gain that is, or would be, excluded from passive income pursuant to section 954(c)(2)(C) is treated as a non-passive asset.

(e) *Stapled stock*. For purposes of determining whether stapled entities (as defined in section 269B(c)(2)) are a PFIC, all entities that are stapled entities with respect to each other are treated as a single entity that holds all of the assets of the stapled entities, conducts all of the activities of the stapled entities, and derives all of the income of the stapled entities.

(f) *Definitions*. The following definitions apply for purposes of this section:

(1) *Look-through partnership*. The term *look-through partnership* means, with respect to a tested foreign corporation—

(i) For purposes of section 1297(a)(2), a partnership at least 25 percent of the value of which is owned (as determined under §1.1297-2(b)(1) as if the partnership were a corporation) by the tested foreign corporation on the measuring date; and

(ii) For purposes of section 1297(a)(1), a partnership for which the value owned (as determined under §1.1297-2(b)(1) as if the partnership were a corporation) by the tested foreign corporation on the date on which income is received or accrued by the partnership is at least 25 percent of the value of the partnership.

(2) *Measuring date*. The term *measuring date* has the meaning provided in paragraph (d)(1)(i) of this section.

(3) *Measuring period*. The term *measuring period* means a quarter or an alternative measuring period, as determined in accordance with paragraph (d)(1)(ii) of this section.

(4) *Non-passive asset*. The term *non-passive asset* means an asset other than a passive asset.

(5) *Non-passive income*. The term *non-passive income* means income other than passive income.

(6) *Passive asset*. The term *passive asset* means an asset that produces passive income, or which is held for the production of passive income, taking into account the rules in paragraphs (c) and (d) of this section.

(7) *Passive income*. The term *passive income* has the meaning provided in paragraph (c)(1) of this section.

(8) *Tested foreign corporation*. The term *tested foreign corporation* means a foreign corporation the PFIC status of which is being tested under section 1297(a).

(g) *Applicability date*. (1) [Reserved]

(2) *In general*. The rules of this section apply to taxable years of shareholders beginning on or after the date of publication of the Treasury decision adopting these rules as final regulations in the **Federal Register**.

§1.1297-2 Special rules regarding look-through subsidiaries.

(a) *Overview*. This section provides rules concerning the treatment of income and assets of a look-through subsidiary for purposes of determining whether a tested foreign corporation (as defined in §1.1297-1(f)(8)) is a passive foreign investment company (PFIC) under section 1297(a). Paragraph (b) of this section provides guidance for purposes of section 1297(c) on how to determine a tested foreign corporation's ownership in a corporation and how to determine a tested foreign corporation's proportionate share of a look-through subsidiary's assets and income. Paragraph (c) of this section provides rules that eliminate certain income and assets related to look-through subsidiaries and look-through partnerships (as defined in §1.1297-1(f)(1)) for purposes of determining a tested foreign corporation's PFIC status. Paragraph (d) of this section sets forth a rule to determine whether certain income received or accrued by look-through subsidiaries and look-through partnerships is received or accrued from a related person for purposes of section 1297(b)(2)(C). Paragraph (e) of this section sets forth rules concerning the attribution of activities from a look-through subsidiary or look-through partnership. Paragraph (f) of this section provides rules for determining the amount of gain from the sale or exchange of stock of a look-through subsidiary that is taken into account under section 1297(a) and for determining the passive or non-passive character of the gain. Paragraph (g) of this section sets forth definitions applicable for this section, and paragraph (h) of this section sets forth the applicability date of this section.

(b) *General rules*—(1) *Tested foreign corporation's ownership of a corporation*. For purposes of section 1297(c) and the regulations in this section, the principles of section 958(a) and the regulations in this chapter under that section applicable to determining direct or indirect ownership by value apply to determine a tested foreign corporation's percentage ownership (by value) in the stock of another corporation. These principles apply whether an intermediate entity is domestic or foreign.

(2) *Tested foreign corporation's proportionate share of the assets and income of a look-through subsidiary*—(i) *Proportionate share of assets*. For each measuring period (as defined in §1.1297-1(f)(3)), a tested foreign corporation is treated as if it held its proportionate share of each asset of a look-through subsidiary, determined based on the tested foreign corporation's percentage ownership (by value) (as determined under paragraph (b)(1) of this section)) of the look-through subsidiary on the measuring date (as defined in §1.1297-1(f)(2)).

(ii) *Proportionate share of income*—(A) *General rule*. A tested foreign corporation is treated as if it received directly its proportionate share of each item of gross income of a corporation for a taxable year if the corporation is a look-through subsidiary with respect to the tested foreign corporation for the taxable year of the tested foreign corporation. In such case, a tested foreign corporation's proportionate share of a look-through subsidiary's gross income is determined based on the corporation's average percentage ownership (by value) of the look-through subsidiary.

(B) *Special rule*. When a corporation is not a look-through subsidiary with respect to a tested foreign corporation for a taxable year of the tested foreign corporation, the tested foreign corporation may be treated as if it received directly its proportionate share of the gross income of the first corporation for each measuring period in the year for which the first corporation is a look-through subsidiary, provided that the gross income of the first corporation for each such measuring period can be established. In such case, a tested foreign corporation's proportionate share of a look-through subsidiary's gross income is determined based on the tested foreign corporation's percentage ownership (by value) (as determined under paragraph (b)(1) of this section) of the look-through subsidiary on the relevant measuring date.

(iii) *Coordination of section 1297(c) with section 1298(b)(7)*. A tested foreign corporation is not treated under section 1297(c) and this paragraph (b) as holding its proportionate share of the assets of a domestic corporation, or receiving directly its proportionate share of the gross income of such corporation, if the stock of the corporation is treated as an asset that is not a passive asset (as defined in §1.1297-1(f)(6)) that produces income that is not passive income (as defined in §1.1297-1(f)(7)) under section 1298(b)(7) (concerning the treatment of certain foreign corporations owning stock in certain 25 percent owned domestic corporations). See §1.1298-4 for rules governing the application of section 1298(b)(7).

(3) *Examples*. The following examples illustrate the rules of this paragraph (b). For purposes of the examples in this paragraph (b)(3), for TFC's and LTS's entire taxable years, USP is a domestic corporation; USP owns 30% of TFC; TFC owns the amount of stock of LTS provided in each example; LTS owns 25% of the only class of FS stock; and TFC, LTS, and FS are foreign corporations that are not controlled foreign corporations within the meaning of section 957(a).

(i) *Example 1*—(A) *Facts*. TFC directly owns 80% of the only class of LTS stock for TFC's and LTS's entire taxable year. Pursuant to the principles of section 958(a), TFC owns 80% of the value of LTS, LTS owns 25% of the value of FS, and TFC owns 20% of the value of FS.

(B) *Results*. Under paragraph (b) of this section, in determining whether LTS is a PFIC under section 1297(a), LTS is treated as if it held 25% of each of FS's assets on each of the measuring dates in its taxable year, and received directly 25% of the gross income of FS for the taxable year. In determining whether TFC is a PFIC under section 1297(a), TFC is treated as if it held an 80% interest in each of LTS's assets on each of the measuring dates in its taxable year, and received directly 80% of the income of LTS for the taxable year. However, TFC is treated as if it held a 20% interest in the stock of FS (and not the assets of FS), and received 80% of any dividends paid from FS to LTS (and not any income of FS).

(ii) *Example 2*—(A) *Facts*. TFC directly owns 25% of the only class of LTS stock on the last day of each of the first three quarters of its taxable year, but disposes of its entire interest in LTS during the fourth quarter of its taxable year. Pursuant to the principles of section 958(a), on each of its first three measuring dates, TFC owns 25% of the value of LTS and 6.25% of the value of FS.

(B) *Results*. Under paragraph (b) of this section, in determining whether TFC is a PFIC under section 1297(a), TFC is treated as if it held 25% of LTS's assets on each of the first three measuring dates in its taxable year. However, because it held an average of 18.75% of the value of LTS on the measuring dates in the taxable year, it is not treated as receiving directly the gross income of LTS for the taxable year. If information about the gross income for LTS for each of the first three quarters of its taxable year is available, TFC may be treated as receiving directly 25% of the income of LTS for each of those quarters, because it owned 25% of the value of LTS on the measuring dates with respect to those measuring periods. For each of its first three quarters, TFC is treated as if it held a 6.25% interest in the stock of FS (and not the assets of FS) and may, if information about the income for LTS for each of the first three quarters of its taxable year is available, be treated as receiving 25% of any dividends paid from FS to LTS (and not any income of FS).

(iii) *Example 3*—(A) *Facts*. TFC directly owns 100% of the only class of LTS stock for TFC's and LTS's entire taxable year. Pursuant to the principles of section 958(a), TFC owns 100% of the value of LTS, and TFC owns 25% of the value of FS. TFC earns $5x of rents from renting a building to LTS, a related person with respect to TFC within the meaning of section 954(d)(3). TFC also sells one item of property described in section 954(c)(1)(B)(i) for a gain of $25x and another for a loss of $10x, and no exception from passive income applies to either amount. LTS has $100x of revenues from selling property described in section 1221(a)(1) to unrelated persons, but $150x of cost of goods sold with respect to such property. None of LTS's deduction for the rent paid to TFC is allocated to non-passive income under the principles of §§1.861-8 through 1.861-14T. During the taxable year, FS sells one item of property described in section 954(c)(1)(B)(i) for a gain of $50x and another for a loss of $100x, and no exception from passive income applies to either amount.

(B) *Results*. Under paragraph (b) of this section, in determining whether TFC is a PFIC under section 1297(a), TFC is treated as if it held 100% of LTS's assets on each of the measuring dates in its taxable year, and received directly 100% of the gross income of LTS for the taxable year. Accordingly, TFC is treated as receiving directly $0x of gross income from the sale of property by LTS given that LTS revenues are fully offset by costs of goods sold. Furthermore, TFC is treated as if it held a 25% interest in FS's assets, and received directly 25% of the gross income of FS. Pursuant to §1.1297-1(c)(1)(ii), only the excess of gains over losses from property transactions described in section 954(c)(1)(B) is taken into account as gross income for purposes of section 1297. Accordingly, TFC is treated as receiving directly $0x of gross income from the sales of property by FS. TFC's rental income constitutes passive income pursuant to §1.1297-1(c) and section 954(c)(1)(A), the exception in section 954(c)(2)(A) does not apply, and, taking into account §1.1297-1(c)(3)(iii), section 1297(b)(2)(c) does not apply to characterize any of the rental income as non-passive income. TFC's income from its sales of property constitutes passive income pursuant to §1.1297-1(c) and section 954(c)(1)(B), although, pursuant to §1.1297-1(c)(1)(ii), only the excess of gains over losses is taken into account as gross income for purposes of section 1297. As a result, TFC's income, all of which is passive income, equals $20x ($5x + ($25x-$10x)) of gross income.

(c) *Elimination of certain intercompany assets and income*—(1) *General rule for asset test*. For purposes of section 1297, a tested foreign corporation does not take into account the value (or adjusted basis) of stock of a look-through subsidiary (*LTS stock*) or its proportionate share of an obligation of a look-through subsidiary (*LTS debt*) that it owns on a measuring date, including LTS stock and LTS debt that it is treated as owning pursuant to section 1297(c) and paragraph (b)(2) of this section or §1.1297-1(c)(2). The tested foreign corporation's proportionate share of a LTS debt is the value (or adjusted basis) of the debt multiplied by the tested foreign corporation's percentage ownership (by value) in the debtor look-through subsidiary. Furthermore, for purposes of section 1297, a tested foreign corporation does not take into account the value (or adjusted basis) of stock or obligations of the tested foreign corporation that it is treated as owning pursuant to section 1297(c) and paragraph (b)(2) of this section or §1.1297-1(c)(2).

(2) *General rule for income test*. For purposes of section 1297, a tested foreign corporation does not take into account dividends derived with respect to LTS stock or its proportionate share of interest derived with respect to LTS debt, including amounts that it is treated as receiving pursuant to section 1297(c) and paragraph (b)(2) of this section or §1.1297-1(c)(2), other than dividends that are attributable to income that was not treated as received directly by the tested foreign corporation pursuant to paragraph (b)(2) of this section. The tested foreign corporation's proportionate share of interest is the amount of interest multiplied by the tested foreign corporation's percentage ownership (by value) in the debtor look-through subsidiary. Furthermore, for purposes of section 1297, a tested foreign corporation does not take into account dividends or interest with respect to stock or obligations of the tested foreign corporation that it is treated as receiving pursuant to section 1297(c) and paragraph (b)(2) of this section or §1.1297-1(c)(2).

(3) *Partnerships*. For purposes of section 1297, the principles of paragraphs (c)(1) and (2) of this section apply with respect to ownership interests in and debt of a look-through partnership and with respect to distributions by a look-through partnership, other than distributions that are attributable to income that was not treated as received directly by the tested foreign corporation pursuant to §1.1297-1(c)(2), and interest derived with respect to the debt of a look-through partnership.

(4) *Examples*. The following examples illustrate the rules of this paragraph (c). For purposes of the examples in this paragraph (c)(4), USP is a domestic corporation; USP owns 30% of TFC; TFC, LTS1, and LTS2 are foreign corporations that are not controlled foreign corporations within the meaning of section 957(a); FPS is a foreign partnership; and TFC, LTS1, and LTS2 measure assets for purposes of section 1297(a)(2) based on value.

(i) *Example 1*—(A) *Facts*. TFC directly owns 40% of the value of LTS1 stock on each of the measuring dates, and thus is treated under paragraph (b)(1) of this section as owning 40% of LTS1 on each of the measuring dates. TFC's assets include a loan to LTS1 with a balance of $1,000x on each of the measuring dates. During the first quarter of the taxable year, TFC received $20x of dividends from LTS1, which were attributable to income of LTS1 treated as received directly by TFC pursuant to paragraph (b)(2) of this section, and $30x of interest on the loan, both of which were paid in cash.

(B) *Results*. Under paragraph (c) of this section, for purposes of applying section 1297(a), TFC's assets do not include the stock of LTS1, and TFC's income does not include the $20x of dividends received from LTS1. Similarly, TFC's assets include only $600x ($1,000x loan – (40% x $1,000x)) of the loan to LTS1, and TFC's income includes only $18x ($30x interest – (40% x $30x)) of the interest from LTS1. However, TFC's assets include the entire $50x of cash ($20x of dividends and $30x of interest) received from LTS1.

(ii) *Example 2*—(A) *Facts*. The facts are the same as in paragraph (c)(4)(i)(A) of this section (the facts in *Example 1*), except that TFC also directly owns 30% of the value of LTS2 stock on each of the measuring dates, and thus is treated under paragraph (b)(1) of this section as owning 30% of LTS2, and LTS1's assets also include a loan to LTS2 with a balance of $200x on each of the measuring dates. During the first quarter of the taxable year, LTS1 received $5x of interest on the loan, which was paid in cash.

(B) *Results*. The results are the same as in paragraph (c)(4)(i)(B) of this section (the results in *Example 1*), except that TFC's assets also do not include the stock of LTS2. Similarly, although TFC would be treated under paragraph (b)(2) of this section as owning $80x (40% x $200x) of the LTS1 loan to LTS2, under paragraph (c) of this section, TFC does not take into account $60x (30% x $200x)) of the loan to LTS2, and accordingly, its assets include only $20x ($80x-$60x) of the loan to LTS1. Furthermore, although TFC would be treated under paragraph (b)(2) of this section as receiving $2x (40% x $5x) of the interest received by LTS1 from LTS2, under paragraph (c) of this section, TFC does not take into account $1.5x (30% x $5x) of the interest received by LTS1, and accordingly, its income includes only $0.5x ($2x-$1.5x) of the interest from LTS2. Furthermore, TFC's assets include $2x (40% x $5x) of LTS1's cash received from LTS2.

(iii) *Example 3*—(A) *Facts*. TFC directly owns 80% of the value of LTS1 stock on each of the measuring dates, and thus is treated under paragraph (b)(1) of this section as owning 80% of LTS1 on each of the measuring dates. TFC also directly owns 50% of the value in FPS on each of the measuring dates. LTS1's assets include the remaining 50% of the value in FPS and a loan to FPS with a balance of $500x on each of the measuring dates. FPS's assets include a loan to TFC with a balance of $1000x on each of the measuring dates. During the first measuring period of the taxable year, FPS received $30x of interest from TFC, and LTS1 received $15x of interest from FPS, both of which were paid in cash. During the last measuring period of the taxable year, FPS received $80x of income from an unrelated person in cash and distributed $60x of such income in cash to TFC and LTS1 in proportion to their interests in FPS.

(B) *Results*. Under paragraph (c) of this section, for purposes of applying section 1297(a), TFC's assets do not include the stock of LTS1, the interests in FPS owned by TFC directly and through LTS1, any of the loan by FPS to TFC, or any of the loan by LTS1 to FPS. Similarly, TFC's income does not include any of the $30x of interest received by FPS from TFC, any of the $15x of interest received by LTS1 from FPS, or any of the $60x of distributions received by TFC and LTS1 from FPS. However, on each of the measuring dates, TFC's assets include $27x ((50% x $30x) + (80% x 50% x $30x)) of the $30 of cash received by FPS from TFC and $12x (80% x $15x) of the $15 of cash received by LTS1 from FPS. Moreover, on the last measuring date of the taxable year, TFC's assets include $18x ((50%

x $20x) + (80% x 50% x $20x)) of the $20x ($80x - $60x) of cash received by FPS from the unrelated person and retained and $54 ((50% x $60x) + (80% x 50% x $60x)) of the $60x cash received by FPS from the unrelated person and distributed. Furthermore, TFC's income includes $72x ((50% x $80x) + (80% x 50% x $80x)) of the $80x of income received by FPS from an unrelated person.

(d) *Related person determination for purposes of section 1297(b)(2)(C)*—(1) *General rule*. For purposes of section 1297(b)(2)(C), interest, dividends, rents, or royalties received or accrued by a look-through subsidiary (and treated as received directly by a tested foreign corporation pursuant to section 1297(c) and paragraph (b)(2) of this section) are considered received or accrued from a related person only if the payor of the interest, dividend, rent or royalty is a related person (within the meaning of section 954(d)(3)) with respect to the look-through subsidiary, taking into account §1.1297-1(c)(1)(i)(D). Similarly, for purposes of 1297(b)(2)(C), interest, dividends, rents, or royalties received or accrued by a look-through partnership (and treated as received directly by a tested foreign corporation pursuant to §1.1297-1(c)(2)) are considered received or accrued from a related person only if the payor of the interest, dividend, rent or royalty is a related person (within the meaning of section 954(d)(3)) with respect to the look-through partnership, taking into account §1.1297-1(c)(1)(i)(D).

(2) *Example*. The following example illustrates the rule of this paragraph (d).

(i) *Facts*. USP is a domestic corporation that owns 30% of TFC. TFC directly owns 30% of the value of FS1 stock, and thus under paragraph (b) of this section is treated as owning 30% of FS1. FS1 directly owns 60% of the vote of FS2 stock and 20% of the value of FS2 stock. The remaining vote and value of FS2 stock are owned by an unrelated foreign person. TFC, FS1, and FS2 are foreign corporations that are not controlled foreign corporations within the meaning of section 957(a). FS1 receives a $100x dividend from FS2.

(ii) *Results*. Pursuant to section 1297(c) and paragraph (b)(2) of this section, TFC is treated as receiving directly $30x of the dividend income received by FS1. FS2 is a "related person" with respect to FS1 for purposes of section 1297(b)(2)(C) because FS1 owns more than 50% of the vote of FS2. FS2 is not a "related person" with respect to TFC for purposes of section 1297(b)(2)(C). Under paragraph (d) of this section, for purposes of determining whether the dividend income received by FS1 is subject to the exception in section 1297(b)(2)(C) for purposes of testing the PFIC status of TFC, the dividend is treated as received from a related person because FS1 and FS2 are related persons within the meaning of section 1297(b)(2)(C). Therefore, to the extent the dividend income received by FS1 would be properly allocable to income of FS2 that is not passive income, the dividend income that TFC is treated as receiving under section 1297(c) is treated as non-passive income (as defined in §1.1297-1(f)(5)).

(e) *Treatment of activities of certain look-through subsidiaries and look-through partnerships for purposes of section 954(c)(2)(A) active rents and royalties exception*—(1) *General rule*. An item of rent or royalty income received by a tested foreign corporation (including an amount treated as received or accrued pursuant to section 1297(c) and paragraph (b)(2) of this section or pursuant to §1.1297-1(c)(2)) that would be passive income in the hands of the entity that actually received or accrued it is not passive income pursuant to §1.1297-1(c)(1)(i)(A) and section 954(c)(2)(A) if the item would be excluded from foreign personal holding company income under section 954(c)(2)(A) and §1.954-2(b)(6), (c), and (d), determined by taking into account the activities performed by the officers and staff of employees of the tested foreign corporation as well as activities performed by the officers and staff of employees of any look-through subsidiary in which the tested foreign corporation owns more than 50 percent by value (as determined under paragraph (b)(1) of this section) and any look-through partnership in which the tested foreign corporation owns, directly or indirectly, more than 50 percent.

(2) *Examples*. The following examples illustrate the rule of this paragraph (e).

(i) *Example 1*—(A) *Facts*. USP is a domestic corporation that directly owns 20% of the outstanding stock of FS1. The remaining 80% of the outstanding stock of FS1 is directly owned by a foreign person that is not related to USP. FS1 directly owns 100% of the value of the outstanding stock of FS2 and directly owns 80% of the value of the outstanding stock of FS3. The remaining 20% of the outstanding stock of the value of the FS3 is directly owned by a foreign person that is not related to USP. FS2 directly owns 80% of the value of the outstanding stock of FS4. The remaining 20% of the value of the outstanding stock of FS4 is directly owned by a foreign person that is not related to USP. FS1, FS2, FS3 and FS4 are all organized in Country A and are not controlled foreign corporations within the meaning of section 957(a). FS4 owns real property that is leased to a person that is not a related person, but does not perform any activities. FS1 and FS2 also do not perform any activities. Officers and employees of FS3 in Country A perform activities with respect to the real property of FS4 that, if performed by officers or employees of FS4, would allow the rental income in the hands of FS4 to qualify for the exception from foreign personal holding company income in section 954(c)(2)(A) and §1.954-2(b)(6) and (c)(1)(ii).

(B) *Results*. Under this paragraph (e), for purposes of determining whether the rental income treated under section 1297(c) and paragraph (b)(2) of this section as received directly by FS1 with respect to the real property owned and rented by FS4 is passive income for purposes of section 1297, the activities of FS3 are taken into account as a result of FS1's ownership of 80% by value (as determined under paragraph (b)(1) of this section) of FS3. Thus, the exception in section 954(c)(2)(A) would apply, and the rental income treated as received by FS1 would be treated as non-passive income for purposes of determining whether FS1 is a PFIC. Because FS2 and FS4 do not own more than 50 percent by value (as determined under paragraph (b)(1) of this section) of FS3, the activities of FS3 are not taken into account for purposes of determining whether the rental income treated as received by FS2 and actually received by FS4 with respect to the real property owned and rented by FS4 is passive income for purposes of section 1297. Thus, the exception in section 954(c)(2)(A) would not apply, and the rental income treated as received by FS2 and actually received by FS4 would be treated as passive income for purposes of determining whether FS2 and FS4 are PFICs.

(ii) *Example 2*—(A) *Facts*. The facts are the same as in paragraph (e)(2)(i)(A) of this section (the facts in *Example 1*), except that FS2 also owns real property that is leased to a person that is not a related person, and the officers and employees of FS2 in Country A engage in activities that would allow rental income received by FS2 with respect to its real property to qualify for the exception in section 954(c)(2)(A) and §1.954-2(b)(6) and (c)(1)(iv), relying on the rule in §1.954-2(c)(2)(ii) that provides that an organization is substantial in relation to rents if active leasing expenses equal or exceed 25 percent of adjusted leasing profit. However, the active leasing expenses of FS1 are less than 25 percent of its adjusted leasing profit, which includes the rental income of FS4 treated as received directly by FS1 as well as the rental income of FS2 treated as received directly by FS1.

(B) *Results*. Because FS2's rental income constitutes non-passive income as a result of the application of §1.1297-1(c)(1)(i)(A) and section 954(c)(2)(A), it is treated as non-passive income treated as received by FS1 for purposes of determining whether FS1 is a PFIC, and accordingly, it is not necessary to rely on paragraph (e) of this section.

(f) *Gain on disposition of stock in a look-through subsidiary*—(1) *Amount of gain taken into account*. The amount of gain derived from a tested foreign corporation's direct disposition of stock of a look-through subsidiary, or an indirect disposition resulting from the disposition of stock of a look-through subsidiary by other look-through subsidiaries or by look-through partnerships, that is taken into account by the tested foreign corporation for purposes of section 1297(a)(1), section 1298(b)(3), and §1.1298-2 is the residual gain. The residual gain equals the total gain recognized by the tested foreign corporation (including gain treated as recognized by the tested foreign corporation pursuant to section 1297(c) and paragraph (b)(2) of this section or §1.1297-1(c)(2)) from the disposition of the stock of the look-through subsidiary reduced (but not below zero) by unremitted earnings. *Unremitted earnings* are the excess (if any) of the aggregate income (if any) taken into account by the tested foreign corporation pursuant to section 1297(c) and paragraph (b)(2) of this section or §1.1297-1(c)(2) with respect to the stock of the disposed-of look-through subsidiary (including with respect to any other look-through subsidiary, to the extent it is owned by the tested foreign corporation indirectly through the disposed-of look-through subsidiary) over the aggregate dividends (if any) received by the tested foreign corporation from the disposed-of look-through subsidiary with respect to the stock. For purposes of this paragraph (f)(1), the amount of gain derived from the disposition of stock of a look-through subsidiary and income of and dividends received from the look-through subsidiary is determined on a share-by-share basis.

(2) *Characterization of residual gain as passive income*. For purposes of section 1297(a)(1), section 1298(b)(3), and §1.1298-2, the residual gain is characterized as passive income or non-passive income based on the relative amounts of passive assets and non-passive assets (as defined in §1.1297-1(f)(6) and (4), respectively) of the disposed-of look-through subsidiary (and any other look-through subsidiary to the extent owned indirectly through the look-through subsidiary) treated as held by the tested foreign corporation on the date of the disposition of the look-through subsidiary. For the purpose of this paragraph (f)(2), the relative amounts of passive assets and non-passive assets held by the look-through subsidiary are measured under the same method (value or adjusted bases) used to measure the assets of the tested foreign corporation for purposes of section 1297(a)(2).

(3) *Examples*. The following examples illustrate the rules of this paragraph (f). For purposes of the examples in this paragraph (f)(3), USP is a domestic corporation, TFC and FS are foreign corporations that are not controlled foreign corporations within the meaning of section 957(a), and USP, TFC, and FS each has outstanding a single class of stock with 100 shares outstanding and a calendar taxable year.

(i) *Example 1*—(A) *Facts*. USP owned 30% of the outstanding stock of TFC throughout Years 1, 2, 3, and 4. In Year 1, TFC purchased 5 shares of FS stock, representing 5% of the stock of FS, from an unrelated person. On the first day of Year 3, TFC purchased 20 shares of FS stock, representing 20% of the stock of FS, from an unrelated person. TFC owned 25% of the outstanding stock of FS throughout Years 3 and 4. Prior to Year 3, TFC did not include any amount in income with respect to FS under section 1297(c)(2). During Years 3 and 4, for purposes of section 1297(a)(1), TFC included in income, in the aggregate, $40x of income with respect to FS under section 1297(c) and paragraph (b)(2) of this section. TFC did not receive dividends from FS during Year 1, 2, 3, or 4. For purposes of section 1297(a)(2), TFC measures its assets based on their fair market value as provided under section 1297(e). On the last day of Year 4, TFC recognizes a loss with respect to the sale of 5 shares of FS stock, and a $110x gain with respect to the sale of 20 shares of FS stock. On the date of the sale, FS owns non-passive assets with an aggregate fair market value of $150x, and passive assets with an aggregate fair market value of $50x.

(B) *Results*. For purposes of applying section 1297(a)(1) to TFC for Year 4, TFC must take into account $78x of residual gain, as provided by paragraph (f)(1) of this section, which equals the amount by which the $110x gain recognized on the sale of 20 shares exceeds the aggregate pro rata share of $32x income ($40x x 20/25) taken into account by TFC with respect to the 20 shares in FS under section 1297(c) and paragraph (b)(2) of this section during Years 3 and 4. There is zero residual gain on the sale of 5 shares of FS stock because they were sold at a loss. Under paragraph (f)(2) of this section, $58.50x of the residual gain is non-passive income ($78x x ($150x/$200x)) and $19.50x is passive income ($78x x ($50x/$200x)).

(ii) *Example 2*—(A) *Facts*. The facts are the same as in paragraph (f)(3)(i)(A) of this section (the facts in *Example 1*), except that in Year 1, TFC purchased 15 shares of FS stock, representing 15% of the stock of FS, from an unrelated person, and on the first day of Year 3, TFC purchased an additional 15 shares of FS stock, representing 15% of the stock of FS, from an unrelated person, and on the last day of Year 4, TFC recognizes gain of $10x of the sale of 15 shares of FS stock purchased in Year 1, and gain of $60x on the sale of the other 15 shares of FS stock purchased in Year 3.

(B) *Results*. For purposes of applying section 1297(a)(1) to TFC for Year 4, TFC must take into account $40x of residual gain, as provided by paragraph (f)(1) of this section, which equals the amount by which the $60x gain recognized on the sale of the 15 shares acquired in Year 3 exceeds the pro rata aggregate share of $20x income ($40x x 15/30) taken into account by TFC with respect to the 15 shares in FS under section 1297(c)(2) during Years 3 and 4. There is zero residual gain on the sale of the other 15 shares of FS stock because the $10x of gain does not exceed the aggregate pro rata share of $20x income taken into account by TFC with respect to the other 15 shares of FS under section 1297(c) and paragraph (b)(2) of this section. Under paragraph (f)(2) of this section, $30x of the residual gain is non-passive income ($40x x ($150x/$200x)) and $10x is passive income ($40x x ($50x/$200x)).

(iii) *Example 3*—(i) *Facts*. The facts are the same as in paragraph (f)(3)(ii)(A) of this section (the facts in *Example 2*), except that TFC received, in the aggregate, $20x of dividends from FS during Year 2.

(B) *Results*. The results are the same as in paragraph (f)(3)(ii)(B) of this section (the results in *Example 2*), except that the residual gain is $50x, which equals the $40x of residual gain attributable to the 15 shares acquired in Year 3, as computed in paragraph (f)(3)(ii)(B) of this section (the results in *Example 2*), plus the $10x of gain recognized on the 15 shares acquired in Year 1 reduced by $0x, the amount by which the pro rata share of aggregate income ($20x) taken into account by TFC with respect to those 15 shares of FS stock under section 1297(c) and paragraph (b)(2) of this section exceeds the aggregate pro rata amount of dividends with respect to those 15 shares of FS stock ($20x) received by TFC from FS. Under paragraph (f)(2) of this section, $35x of the residual gain is non-passive income ($50x x ($150x/$200x)) and $15x is passive income ($50x x ($50x/$200x)).

(g) *Definitions*. The following definitions apply for purposes of this section:

(1) *Look-through subsidiary*. The term *look-through subsidiary* means, with respect to a tested foreign corporation—

(i) For purposes of section 1297(a)(2) and paragraph (b)(2)(i) of this section, a corporation at least 25 percent of the value of the stock of which is owned (as determined under paragraph (b)(1) of this section) by the tested foreign corporation on the measuring date;

(ii) For purposes of section 1297(a)(1)—

(A) For the taxable year, a corporation with respect to which the average percentage ownership (which is equal to the percentage ownership (by value) (as determined under paragraph (b)(1) of this section)) on each measuring date during the taxable year, divided by the number of measuring dates in the year) by the tested foreign corporation during the tested foreign corporation's taxable year is at least 25 percent; or

(B) For a measuring period, a corporation at least 25 percent of the value of the stock of which is owned (as determined under paragraph (b)(1) of this section) by the tested foreign corporation on the measuring date, provided all items of gross income of the corporation for each of the measuring periods in the taxable year for which the tested foreign corporation owns at least 25 percent of the value (as determined under paragraph (b)(1) of this section) on the relevant measuring dates can be established; and

(iii) For purposes of paragraph (f) of this section and §1.1298-2, a corporation at least 25 percent of the value of the stock of which is owned (as determined under paragraph (b)(1) of this section) by the tested foreign corporation immediately before the disposition of stock of the corporation.

(2) *LTS debt*. The term *LTS debt* has the meaning provided in paragraph (c)(1) of this section.

(3) *LTS stock*. The term *LTS stock* has the meaning provided in paragraph (c)(1) of this section.

(4) *Residual gain*. The term *residual gain* has the meaning provided in paragraph (f)(1) of this section.

(5) *Unremitted earnings*. The term *unremitted earnings* has the meaning provided in paragraph (f)(1) of this section.

(h) *Applicability date*. The rules of this section apply to taxable years of shareholders beginning on or after the date of publication of the Treasury decision adopting these rules as final regulations in the **Federal Register**.

Par.6 Sections 1.1297-4 and 1.1297-5 are added to read as follows:

§1.1297-4 Qualifying insurance corporation.

(a) *Scope*. This section provides rules for determining whether a foreign corporation is a qualifying insurance corporation for purposes of section 1297(f). Paragraph (b) of this section provides the general rule for determining whether a foreign corporation is a qualifying insurance corporation. Paragraph (c) of this section describes the 25 percent test in section 1297(f)(1)(B). Paragraph (d) of this section contains rules for applying the alternative facts and circumstances test in section 1297(f)(2). Paragraph (e) of this section contains rules limiting the amount of applicable insurance liabilities for purposes of the 25 percent test described in paragraph (c) of this section and the alternative facts and circumstances test described in paragraph (d) of this section. Paragraph (f) of this section provides definitions that apply for purposes of this section. Paragraph (g) of this section provides the applicability date of this section.

(b) *Qualifying insurance corporation*. For purposes of section 1297(b)(2)(B), this section and §1.1297-5, a qualifying insurance corporation (QIC) is a foreign corporation that—

(1) Is an insurance company as defined in section 816(a) that would be subject to tax under subchapter L if the corporation were a domestic corporation; and

(2) Satisfies—

(i) The 25 percent test described in paragraph (c) of this section; or

(ii) The requirements for an election to apply the alternative facts and circumstances test as described in paragraph (d) of this section and a United States person has made an election as described in paragraph (d)(5) of this section.

(c) *25 percent test*. A foreign corporation satisfies the 25 percent test if the amount of its applicable insurance liabilities exceeds 25 percent of its total assets. This determination is made on the basis of the liabilities and assets reported on the corporation's applicable financial statement for the last year ending with or within the taxable year.

(d) *Election to apply the alternative facts and circumstances test*—(1) *In general*. A United States person that owns stock in a foreign corporation that fails to qualify as a QIC solely because of the 25 percent test may elect to treat the stock of the corporation as stock of a QIC if the foreign corporation—

(i) Is predominantly engaged in an insurance business as described in paragraph (d)(2) of this section;

(ii) Failed to satisfy the 25 percent test solely due to runoff-related circumstances, as described in paragraph (d)(3) of this section, or rating-related circumstances, as described in paragraph (d)(4) of this section; and

(iii) Reports an amount of applicable insurance liabilities that is at least 10 percent of the amount of the total assets on its applicable financial statement for the last annual reporting period ending with or within the corporation's taxable year (the *10 percent test*).

(2) *Predominantly engaged in an insurance business*—(i) *In general*. A foreign corporation is predominantly engaged in an insurance business in any taxable year during which more than half of the business of the foreign corporation is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies. This determination is made based on whether the particular facts and circumstances of the foreign corporation are comparable to commercial insurance arrangements providing similar lines of coverage to unrelated parties in arm's length transactions. The fact that a foreign corporation has been holding itself out as an insurer for a long period is not determinative of whether the foreign corporation is predominantly engaged in an insurance business.

(ii) *Facts and circumstances*. Facts and circumstances to consider in determining whether a foreign corporation is predominantly engaged in an insurance business include—

(A) Claims payment patterns for the current year and prior years;

(B) The foreign corporation's loss exposure as calculated for a regulator or for a credit rating agency, or, if those are not calculated, for internal pricing purposes;

(C) The percentage of gross receipts constituting premiums for the current and prior years; and

(D) The number and size of insurance contracts issued or taken on through reinsurance by the foreign corporation.

(iii) *Examples of facts indicating a foreign corporation is not predominantly engaged in an insurance business*. Examples of facts that may indicate a foreign corporation is not predominantly engaged in an insurance business include—

(A) A small overall number of insured risks with low likelihood but large potential costs;

(B) Employees and agents of the foreign corporation focused to a greater degree on investment activities than underwriting activities; and

(C) Low loss exposure.

(3) *Runoff-related circumstances*. During the annual reporting period covered by the applicable financial statement, a foreign corporation fails to satisfy the 25 percent test solely due to runoff-related circumstances only if the corporation—

(i) Was actively engaged in the process of terminating its pre-existing, active insurance or reinsurance underwriting operations pursuant to an adopted plan of liquidation or a termination of operations under the supervision of its applicable insurance regulatory body;

(ii) Did not issue or enter into any insurance, annuity, or reinsurance contract, other than a contractually obligated renewal of an existing insurance contract or a reinsurance contract pursuant to and consistent with the plan of liquidation or a termination of operations; and

(iii) Made payments during the annual reporting period covered by the applicable financial statement to satisfy the claims under insurance, annuity, or reinsurance contracts, and the payments cause the corporation to fail to satisfy the 25 percent test.

(4) *Rating-related circumstances*. A foreign corporation fails to satisfy the 25 percent test solely due to rating-related circumstances only if—

(i) The 25 percent test is not met as a result of the specific requirements with respect to capital and surplus that a generally recognized credit rating agency imposes; and

(ii) The foreign corporation complies with the requirements of the credit rating agency in order to maintain the minimum credit rating required for the foreign corporation to be classified as secure to write new insurance business for the current year.

(5) *Election*—(i) *In general*. A United States person may make the election under section 1297(f)(2) if the foreign corporation directly provides the United States person a statement, signed by a responsible officer of the foreign corporation or an authorized representative of the foreign corporation, or the foreign corporation makes a publicly available statement (such as in a public filing, disclosure statement, or other notice provided to United States persons that are shareholders of the foreign corporation) that it satisfied the requirements of section 1297(f)(2) and paragraph (d)(1) of this section during the foreign corporation's the taxable year. However, a United States person may not rely upon any statement by the foreign corporation to make the election under section 1297(f)(2) if the shareholder knows or has reason to know that the statement made by the foreign corporation was incorrect.

(ii) *Information provided by foreign corporation*. In addition to a statement that the foreign corporation satisfied the requirements of section 1297(f)(2) and paragraph (d)(1) of this section, the statement described in paragraph (d)(5)(i) of this section also must include:

(A) The ratio of applicable insurance liabilities to total assets for the taxable year; and

(B) A statement indicating whether the failure to satisfy the 25 percent test described in paragraph (c) of this section was the result of runoff-related or rating-related circumstances, along with a brief description of those circumstances.

(iii) *Time and manner for making the election*. The election described in paragraph (d)(1) of this section must be made by a United States person who owns stock in the foreign corporation (directly or indirectly) by completing the appropriate part of Form 8621 (or successor form) for each year in which the election applies. A United States person must attach the Form 8621 (or successor form) to its Federal income tax return for the taxable year to which the election relates on or before the due date (including extensions) for the filing of the return. The United States person must attach to the Form 8621 the statement provided by the foreign corporation described in paragraph (d)(1) of this section. If the foreign corporation makes a publicly available statement instead of providing a statement to the United States person, the United States person must attach a statement to the Form 8621 incorporating the information provided in the publicly available statement.

(e) *Rules limiting the amount of applicable insurance liabilities*—(1) *In general*. For purposes of determining whether a foreign corporation satisfies the 25 percent test described in paragraph (c) of this section or the 10 percent test described in paragraph (d)(1)(iii) of this section, the rules of this paragraph (e) apply to limit the amount of applicable insurance liabilities of the foreign corporation.

(2) *General limitation on applicable insurance liabilities*. The amount of applicable insurance liabilities may not exceed the lesser of:

(i) The amount of applicable insurance liabilities shown on the most recent applicable financial statement;

(ii) The minimum amount of applicable insurance liabilities required by the applicable law or regulation of the jurisdiction of the applicable regulatory body; or

(iii) For a foreign corporation that prepares a financial statement on the basis of a financial reporting standard for a purpose other than financial reporting, the amount of the applicable insurance liabilities on that financial statement.

(3) *Additional limitation on amount of applicable insurance liabilities for a foreign corporation that does not prepare a financial statement based on a financial reporting standard*—(i) *In general*. If a foreign corporation has an applicable financial statement described in paragraph (f)(1)(iii) of this section and the applicable financial statement does not discount incurred but unpaid losses and loss reserves on an economically reasonable basis, the amount of applicable insurance liabilities may not exceed the amount of applicable insurance liabilities on the applicable financial statement reduced in accordance with the discounting principles that would have applied under a financial reporting standard, if the foreign corporation had prepared a financial statement under a financial reporting standard for the last year ending with or within the taxable year.

(ii) *Choice of accounting method*. The foreign corporation may choose whether to apply generally accepted accounting principles or international financial reporting principles to calculate the discounted amount of its applicable insurance liabilities for purposes of paragraph (e)(3)(i)(B) of this section. If the foreign corporation does not choose between these financial reporting standards, generally accepted accounting principles will apply.

(4) *Changes to financial statements prepared*. Any foreign corporation that has prepared a financial statement on the basis of a financial reporting standard for an annual reporting period that included December 22, 2017, or any subsequent annual reporting period, must continue to prepare its applicable financial statement using a financial reporting standard unless the foreign corporation has a non-Federal tax business purpose for using the annual statement described in paragraph (f)(1)(iii) of this section. If a foreign corporation has no non-Federal tax business purpose for using the annual statement described in paragraph (f)(1)(iii) of this section and does not continue to prepare

an applicable financial statement using a financial reporting standard, its applicable insurance liabilities are treated as $0 for purposes of this section.

(f) *Definitions*. For purposes of this section, the following terms have the meanings described in this paragraph (f).

(1) *Applicable financial statement*. The term *applicable financial statement* means the financial statement that is used by the foreign corporation for financial reporting purposes and that is—

(i) Made on the basis of generally accepted accounting principles;

(ii) Made on the basis of international financial reporting standards, if there is no statement that is made on the basis of generally accepted accounting principles; or

(iii) The annual statement required to be filed with the applicable insurance regulatory body, as defined in paragraph (f)(3) of this section, if there is no statement made on the basis of either general accounting principles or international financial reporting standards. The annual statement required to be filed with the applicable insurance regulatory body must provide complete information regarding the foreign corporation's operations and financial condition for the annual reporting period ending with or within the taxable year.

(2) *Applicable insurance liabilities*. With respect to any life or property and casualty insurance business of a foreign corporation, the term *applicable insurance liabilities* means—

(i) Occurred losses for which the foreign corporation has become liable but has not paid before the end of the last annual reporting period ending with or within the taxable year, including unpaid claims for death benefits, annuity contracts, and health insurance benefits;

(ii) Unpaid expenses (including reasonable estimates of anticipated expenses) of investigating and adjusted unpaid losses described in paragraph (f)(2)(i) of this section; and

(iii) The aggregate amount of reserves (excluding deficiency, contingency, or unearned premium reserves) held for future, unaccrued health insurance claims and claims with respect to contracts providing coverage for mortality or morbidity risks, including annuity benefits dependent upon the life expectancy of one or more individuals.

(3) *Applicable insurance regulatory body*. The term *applicable insurance regulatory body* means the entity that has been established by law to license or authorize a corporation to engage in an insurance business, to regulate insurance company solvency and to which the applicable financial statement is provided.

(4) *Financial reporting standard*. The term *financial reporting standard* means either GAAP or international financial reporting standards.

(5) *Generally accepted accounting principles or GAAP*. The term *generally accepted accounting principles* or *GAAP* means United States generally accepted accounting principles.

(6) *Insurance business*. Solely for purposes of this section, *insurance business* has the meaning described in §1.1297-5(c)(2).

(7) *Total assets*. For purposes of section 1297(f) and this section, a foreign corporation's *total assets* are the aggregate end-of-period value of the real property and personal property that the foreign corporation reports on its applicable financial statement for the last annual accounting period ending with or within the taxable year.

(g) *Applicability date*. This section applies to taxable years of United States persons that are shareholders in certain foreign corporations beginning on or after the date of publication of the Treasury decision adopting these rules as final regulations in the **Federal Register**.

§1.1297-5 Exception from the definition of passive income for active insurance income.

(a) *Scope*. This section provides rules pertaining to the exception from passive income under section 1297(b)(2)(B) for income derived in the active conduct of an insurance business and rules related to certain income of a qualifying domestic insurance corporation. Paragraph (b) of this section provides a general rule that excludes from passive income certain income of a qualifying insurance corporation (QIC) and certain income of a qualifying domestic insurance corporation. Paragraph (c) of this section provides rules for determining the amount of income derived by a QIC in the active conduct of an insurance business. Paragraph (d) of this section defines income of a qualifying domestic insurance corporation that is not treated as passive for purposes of section 1297. Paragraph (e) of this section provides rules excluding certain assets for purposes of the passive asset test under section 1297(a)(2). Paragraph (f) of this section provides rules concerning the treatment of income and assets of certain look-through subsidiaries and look-through partnerships of a QIC. Paragraph (g) of this section provides a rule prohibiting the double counting of any item for purposes of this section. Paragraph (h) of this section provides definitions applicable to the rules of this section. Paragraph (i) of this section provides the applicability date of this section.

(b) *Exclusion from passive income of active insurance income*. For purposes of section 1297 and §1.1297-1, passive income does not include—

(1) Income that a QIC derives in the active conduct of an insurance business as determined under paragraph (c) of this section; and

(2) Income from a qualifying domestic insurance corporation as determined under paragraph (d) of this section, except that this exclusion does not apply to determine whether a tested foreign corporation (as defined in §1.1297-1(f)(8)) is a PFIC for purposes of section 1298(a)(2) and §1.1291-1(b)(8)(ii).

(c) *Income derived by a QIC in the active conduct of an insurance business*—(1) *In general*. Income that a QIC derives in the active conduct of an insurance business is an amount equal to the QIC's passive income (as defined in §1.1297-1(c) and taking into account the exceptions in section 1297(b)(2) other than the exception provided in section 1297(b)(2)(B) and this section) earned with respect to assets of a QIC that are available to satisfy liabilities of the QIC related to its insurance business (as described in paragraph (c)(2) of this section), multiplied by—

(i) 100 percent if the active conduct percentage determined under paragraph (c)(4) of this section equals or exceeds 50 percent; or

(ii) Zero if the active conduct percentage determined under paragraph (c)(4) of this section is less than 50 percent.

(2) *Insurance business*. Solely for purposes of §1.1297-4 and this section, an insurance business is the business of is-

suing insurance and annuity contracts and the reinsuring of risks underwritten by insurance companies, together with those investment activities and administrative services that are required to support (or that are substantially related to) those insurance, annuity, or reinsurance contracts issued or entered into by the QIC.

(3) *Active conduct of an insurance business*—(i) *In general*. For purposes of determining whether a QIC engages in the active conduct of an insurance business, active conduct is determined based on all the facts and circumstances. In general, a QIC actively conducts an insurance business only if the officers and employees of the QIC carry out substantial managerial and operational activities. A QIC's officers and employees are considered to include the officers and employees of another entity only if the QIC satisfies the control test described in paragraph (c)(3)(ii) with respect to the officers and employees of the other entity. In determining whether the officers and employees of the QIC carry out substantial managerial and operational activities, however, the activities of independent contractors are disregarded.

(ii) *Control test*. A QIC's officers and employees are considered to include the officers and employees of another entity when the requirements of paragraphs (c)(3)(ii)(A) through (C) of this section are satisfied.

(A) *Ownership*—(*1*) *Ownership by or of a corporation*. If the other entity is a corporation—

(*i*) The QIC owns, or is considered to own within the meaning of section 958(a), determined without regard to whether an intermediate entity is domestic or foreign, more than 50 percent of the total combined voting power of all classes of stock of the other corporation entitled to vote, and more than 50 percent of the total value of the stock of the other corporation; or

(*ii*) A common parent owns, or is considered to own within the meaning of section 958(a), determined without regard to whether an intermediate entity is domestic or foreign, more than 80 percent of the total combined voting power of all classes of stock entitled to vote and more than 80 percent of the total value of the stock of each of the QIC and the other corporation.

(*2*) *Ownership of a partnership*. If the other entity is a partnership—

(*i*) The QIC owns, directly or indirectly, more than 50 percent of the interests in the capital and profits in the entity; or

(*ii*) A common parent owns, directly or indirectly, more than 80 percent of the interests in the capital and profits in the entity and owns, or is considered to own within the meaning of section 958(a), determined without regard to whether an intermediate entity is domestic or foreign, more than 80 percent of the total combined voting power of all classes of stock entitled to vote and more than 80 percent of the total value of the stock of the QIC.

(B) *Control and supervision*. The QIC exercises regular oversight and supervision over the services performed by the other entity's officers and employees for the QIC.

(C) *Compensation*. The QIC either—

(*1*) Pays directly all the compensation of the other entity's officers and employees attributable to services performed for the production or acquisition of premiums and investment income on assets held to meet its obligations under the insurance, annuity, or reinsurance contracts issued or entered into by the QIC (*insurance services*);

(*2*) Reimburses the other entity for the portion of its expenses, including compensation and related expenses (determined in accordance with section 482 and taking into account all expenses that would be included in the total services costs under §1.482-9(j) and (k)(2)) for the insurance services performed for the QIC or by the other entity's officers and employees; or

(*3*) Otherwise pays arm's length compensation in accordance with section 482 on a fee-related basis to the other entity for the insurance services provided.

(4) *Active conduct percentage*—(i) *In general*. A QIC's active conduct percentage for a taxable year is the percentage calculated (to the nearest percent) by dividing—

(A) The aggregate amount of expenses, including compensation (or reimbursement of compensation) and related expenses, for services of the officers and employees of the QIC (or another entity under an arrangement that satisfies the requirements of paragraph (c)(3)(ii) of this section) incurred by the QIC for the taxable year that are related to the production or acquisition of premiums and investment income on assets held to meet its obligations under the insurance, annuity, or reinsurance contracts issued or entered into by the QIC, by;

(B) The aggregate of—

(*1*) The amount described in paragraph (c)(4)(i)(A) of this section; and

(*2*) The amount of all expenses paid for the taxable year by the QIC to a person other than a person whose services for the QIC are covered by the expenses included in paragraph (c)(4)(i)(A) of this section for the production or acquisition of premiums and investment income on assets held to meet obligations under the insurance, annuity, or reinsurance contracts issued or entered into by the QIC.

(ii) *Related expense determination*. For purposes of determining the amount included in the numerator under paragraph (c)(4)(i)(A) of this section, the cost of compensation and related expenses include all costs in cash or in kind (including stock-based compensation) that, based on analysis of the facts and circumstances, are directly identified with, or reasonably allocated in accordance with the principles of §1.482-9(k)(2) to, the services of the officers and employees of the insurance company (or related party, as appropriate). In general, costs for the purpose of this paragraph (c)(4)(ii) include all resources expended, used, or made available to achieve the specific objective for which the service of the officer or employee is rendered. For the purpose of this paragraph (c)(4)(ii), reference to generally accepted accounting principles or Federal income tax accounting rules may provide a useful starting point but will not necessarily be conclusive regarding inclusion of costs, and such costs do not include interest expense, foreign income taxes (as defined in §1.901-2(a)), or Federal income taxes.

(iii) *Ceding commission*. For purposes of paragraph (c)(4)(i) of this section, ceding commissions are not taken into account in either the numerator or denominator of the active conduct percentage.

(d) *Income of qualifying domestic insurance corporation*. The income of a domestic corporation is income of a qualifying domestic insurance corporation if the domestic corporation is subject to—

(1) Tax as an insurance company under subchapter L of chapter 1 of subtitle A of the Internal Revenue Code; and

(2) Federal income tax on its net income.

(e) *Exclusion of assets for purposes of the passive asset test under section 1297(a)(2)*. For purposes of section 1297 and §1.1297-1, passive assets (as defined in §1.1297-1(f)(6)), do not include—

(1) Assets of a QIC available to satisfy liabilities of the QIC related to its insurance business (as described in paragraph (c)(2) of this section), if the active conduct percentage of the QIC equals or exceeds 50 percent; and

(2) Assets of a qualifying domestic insurance corporation that meets the requirements described in paragraph (d) of this section, except that this exclusion does not apply to determine whether a tested foreign corporation (as defined in §1.1297-1(f)(8)) is a PFIC for purposes of section 1298(a)(2) and §1.1291-1(b)(8)(ii).

(f) *Treatment of income and assets of certain look-through subsidiaries and look-through partnerships for purposes of the section 1297(b)(2)(B) exception*—(1) *General rule*. An item of income treated as received or accrued or an asset treated as held by a QIC pursuant to section 1297(c) and §1.1297-2(b)(2) or pursuant to §1.1297-1(c)(2) or (d)(3) that would be passive income or a passive asset is treated as an item of income or an asset of the QIC for purposes of paragraphs (c) and (e) of this section.

(2) *Applicable statements for tested foreign corporations applying paragraph (f)(1) of this section*. For purposes of paragraph (f)(1) of this section, an item of passive income or passive asset in the hands of an entity other than a QIC (subsidiary entity) may only be treated as an item of income or an asset used in the active conduct of an insurance business by a foreign corporation treated as a QIC for purposes of paragraphs (c) and (e) of this section if the applicable financial statement used to test the QIC status of the foreign corporation includes the assets and liabilities of the subsidiary entity.

(g) *No double counting*. Nothing in this section or §1.1297-4 permits any item to be counted more than once.

(h) *Definitions*. For purposes of this section, the following terms have the meanings described in this paragraph (h).

(1) *Insurance services*. The term *insurance services* has the meaning provided in paragraph (c)(3)(ii)(C)(*1*) of this section.

(2) *Investment activity*. The term *investment activity* means any activity engaged in by a QIC to produce income of a kind that would be passive income (as defined in §1.1297-1(c)). Investment activities include those activities that are required to support or are substantially related to insurance and annuity contracts issued or reinsured by a QIC only to the extent that income produced by the activities is generated by assets available to satisfy liabilities of the QIC related to the insurance business, as described in paragraph (c)(2) of this section.

(3) *Qualifying insurance corporation* or *QIC*. The term *qualifying insurance corporation* or *QIC* has the meaning described in §1.1297-4.

(i) *Applicability date*. This section applies to taxable years of United States persons that are shareholders in certain foreign corporations beginning on or after the date of publication of the Treasury decision adopting these rules as final regulations in the **Federal Register**.

Par. 7. Section 1.1298-0 is amended by:

1. Revising the introductory text.
2. Adding entries for §§1.1298-2 and 1.1298-4 in numerical order.

The revision and additions read as follows:

§1.1298-0 Passive foreign investment company—table of contents.

This section contains a listing of the paragraph headings for §§1.1298-1, 1.1298-2, 1.1298-3, and 1.1298-4.

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Par. 8. Section 1.1298-2 is added to read as follows:

§1.1298-2 Rules for certain corporations changing businesses.

(a) *Overview*. This section provides rules under section 1298(b)(3) and 1298(g) that apply to certain foreign corporations that dispose of one or more active trades or businesses for purposes of determining whether a foreign corporation is treated as a passive foreign investment company (PFIC). Paragraph (b) of this section sets forth a rule that applies to certain foreign corporations that dispose of one or more active trades or businesses. Paragraph (c) of this section provides special rules. Paragraph (d) of this section sets forth a rule for the treatment of the disposition of the stock of a look-through subsidiary (as defined in §1.1297-2(g)(1)). Paragraph (e) of this section provides guidance on the application of the rules in this section. Paragraph (f) provides examples illustrating the application of the rules in this section. Paragraph (g) sets forth the applicability date for this section.

(b) *Change of business exception*. A corporation is not treated as a PFIC for a taxable year if—

(1) Neither the corporation (nor any predecessor) was a PFIC for any prior taxable year;

(2) Either—

(i) Substantially all of the passive income of the corporation for the taxable year is attributable to proceeds from the disposition of one or more active trades or businesses; or

(ii) Following the disposition of one or more active trades or businesses, substantially all of the passive assets of the corporation on each of the measuring dates that occur during the taxable year and after the disposition are attributable to proceeds from the disposition; and

(3) The corporation is not a PFIC for either of the first two taxable years following the taxable year.

(c) *Special rules*. The rules in this paragraph (c) apply for purposes of section 1298(b)(3) and this section.

(1) Income is attributable to proceeds from the disposition of one or more active trades or businesses to the extent the income is derived from the investment of the proceeds from the disposition of assets used in the active trade or businesses.

(2) Assets are attributable to proceeds from the disposition of one or more active trades or businesses only to the extent the assets are the proceeds of the disposition of assets used in the active trade or businesses, or are derived from the investment of the proceeds.

(3) The determination of the existence of an active trade or business and whether assets are used in an active trade or business is made under §1.367(a)-2(d)(2), (3), and (5), except that officers and employees do not include the officers and employees of related entities as provided in §1.367(a)-2(d)(3). However, if activities performed by the officers and staff of employees of a look-through subsidiary of a corporation (including a look-through subsidiary with respect to which paragraph (d) of this section applies) or of a look-through partnership would be taken into account by the corporation pursuant to §1.1297-2(e) if it applied, or if activities performed by a related person would be taken into account by the corporation pursuant to section 954(h)(3)(E), such activities are taken into account for purposes of the determination of the existence of an active trade or business and the determination of whether assets are used in an active trade or business.

(4) In the case of a corporation that satisfies the condition in paragraph (b)(2)(ii) of this section, the condition in paragraph (b)(3) of this section is deemed to be satisfied if the corporation completely liquidates by the end of the taxable year following the year with respect to which the shareholder applies the exception in paragraph (b) of this section.

(d) *Disposition of stock of a look-through subsidiary*. For purposes of paragraph (b) of this section, the proceeds from a tested foreign corporation's disposition of the stock of a look-through subsidiary are treated as proceeds from the disposition of a proportionate share of the assets held by the look-through subsidiary on the date of the disposition, based on the method (value or adjusted bases) used to measure the assets of the tested foreign corporation for purposes of section 1297(a)(2). The proceeds attributable to assets used by the look-through subsidiary in an active trade or business are treated as proceeds attributable to the disposition of an active trade or business.

(e) *Application of change of business exception*. A shareholder can apply the exception in paragraph (b) of this section with respect to a taxable year of a disposition of an active trade or business or an immediately succeeding taxable year, but cannot apply the exception with respect to more than one taxable year for a disposition.

(f) *Examples*. The following examples illustrate the rules of this section. For purposes of the examples in this paragraph (f): USP is a domestic corporation; TFC and FS are foreign corporations that are not controlled foreign corporations (within the meaning of section 957(a)); each corporation has outstanding a single class of stock; USP has owned its interest in TFC since the formation of TFC; each of USP, TFC, and FS have a calendar taxable year; and for purposes of section 1297(a)(2), TFC measures the amount of its assets based on value.

(1) *Example 1*—(i) *Facts*. (A) USP owns 15% of the outstanding stock of TFC. TFC owns 30% of the outstanding stock of FS. FS operates an active trade or business and 100% of its assets are used in the active trade or business. The value of FS's non-passive assets (as defined in §1.1297-1(f)) is $900x; the value of FS's passive assets (which include cash and accounts receivable) is $100x. TFC has not been treated as a PFIC for any taxable year prior to Year 1 and has no predecessor corporations. In addition to holding the FS stock, TFC directly conducts its own active trade or business. The value of TFC's non-passive assets (other than FS stock) is $50x; the value of TFC's passive assets (other than FS stock and assets received during Year 1) is $30x. TFC earns $1x of non-passive income (as defined in §1.1297-1(f)) from its directly conducted active trade or business.

(B) On January 1, Year 1, TFC sells all of its FS stock for $300x. The residual gain computed under §1.1297-2(f)(1) on the sale of the FS stock is $10x. Under §1.1297-2(f)(2), $9x of residual gain is characterized as non-passive income and $1x of residual gain is characterized as passive income. During the first quarter of Year 1 and apart from the sale of the FS stock, TFC earned $20x of passive income from the investment of the proceeds from the disposition of the FS stock, and TFC maintained such earnings as well as the disposition proceeds in cash for the remainder of the year. TFC reinvests the proceeds of the FS stock sale in an active trade or business during Year 2, and, thus, TFC is not a PFIC in Year 2 and Year 3. Less than 75% of TFC's gross income in Year 1 is passive income (($20x + $1x)/($10x + $20x + $1x) = 68%). However, subject to the application of section 1298(b)(3) and this section, TFC would be a PFIC in Year 1 under section 1297(a)(2) because the proceeds from the sale of the FS stock ($300x) together with TFC's other passive assets ($30x + $20x) exceed 50% of TFC's total assets ($300x + $30x + $20x + $50x).

(ii) *Results*. (A) Under paragraph (d) of this section, for purposes of applying section 1298(b)(3)(B)(i) in Year 1, TFC's proceeds from the disposition of the stock of FS that are attributable to assets used by FS in an active trade or business are considered as from the disposition of an active trade or business. Because 100% of FS's assets are used in its active trade or business, all of TFC's proceeds are considered as from the disposition of an active trade or business. Therefore, under paragraph (c)(1) of this section, the passive income considered attributable to proceeds from a disposition of one or more active trades or businesses is $20x (from investment of disposition proceeds). Because TFC reasonably does not expect to be a PFIC in Year 2 and Year 3, and TFC is not, in fact, a PFIC for those years, TFC will not be treated as a PFIC in Year 1 by reason of section 1298(b)(3) and paragraph (b) of this section, based on the satisfaction of the condition in paragraph (b)(2)(i) of this section, assuming that the 95% (($20x/($20x + $1x)) of TFC's passive income for Year 1 that is attributable to proceeds of the disposition of FS's active trade or business constitutes substantially all of its passive income.

(B) TFC would also not be treated as a PFIC in Year 1 by reason of section 1298(b)(3) and paragraph (b) of this section, based on the satisfaction of the condition in paragraph (b)(2)(ii) of this section, assuming that the 91% (($320x x 4)/(($320x + $30x) x 4)) of TFC's passive assets on the quarterly measuring dates during Year 1 following the disposition of the stock of FS that is attributable to proceeds of the disposition of FS's active trade or business constitutes substantially all of its passive assets.

(C) Under paragraph (e) of this section, TFC cannot claim the section 1298(b)(3) exception in relation to the income attributable to the proceeds of the FS stock sale in Year 2.

(2) *Example 2*—(i) *Facts*. The facts are the same as in paragraph (f)(1)(i) of this section (the facts in *Example 1*), except that during the first quarter of Year 1, TFC earned only $10x of passive income from the investment of the proceeds from the disposition of the FS stock and $10x of passive income from its other passive assets and maintained such earnings in cash for the remainder of the year.

(ii) *Results*. The results are the same as in paragraph (f)(1)(ii) of this section (the facts in *Example 1*), except that under paragraph (c)(1) of this section, the passive income considered attributable to proceeds from a disposition of one or more active trades or businesses is $10x. Because 48% ($10x/($10x + $10x + $1x)), and not substantially all, of TFC's passive income for Year 1 is attributable to proceeds of the disposition of FS's active trade or business, TFC does not qualify for the exception from treatment as a PFIC in section 1298(b)(3) for Year 1. However, under paragraphs (b)(2) and (d) of this section, $310x ($300x disposition proceeds + $10x from investment of disposition proceeds) of TFC's passive assets held on each quarterly measuring date after the disposition is considered attributable to the disposition of an active trade or business. Because TFC reasonably does not expect to be a PFIC in Year 2 and Year 3, and TFC is not, in fact, a PFIC for those years, TFC will not be treated as a PFIC in Year 1 by reason of paragraph (b) of this section, based on the satisfaction of the condition in paragraph (b)(2)(ii) of this section, assuming that the 89% (($310x x 4)/(($310x + $10x + $30x) x 4)) of TFC's passive assets on the quarterly measuring dates during Year 1 following the disposition of the stock of FS that is attributable to proceeds of the disposition of FS's active trade or business constitutes substantially all of its passive assets.

(g) *Applicability date*. The rules of this section apply to taxable years of shareholders beginning on or after the date of publication of the Treasury decision adopting these rules as final regulations in the **Federal Register**.

Par.9. Section 1.1298-4 is added to read as follows:

§1.1298-4 Rules for certain foreign corporations owning stock in 25-percent-owned domestic corporations.

(a) *Overview*. This section provides rules under section 1298(b)(7) that apply to certain foreign corporations that own stock in 25-percent-owned domestic corporations (as defined in paragraph (b) of this section) for purposes of determining whether a foreign corporation is a passive foreign investment company (PFIC). Paragraph (b) of this section provides the general rule. Paragraph (c) of this section sets forth rules concerning ownership of 25-percent-owned domestic corporations or qualified stock (as defined in paragraph (b)(2) of this section) through partnerships. Paragraph (d) of this section sets forth rules for determining whether a foreign corporation is subject to the tax imposed by section 531 (the section 531 tax) and for waiving treaty benefits that would prevent the imposition of such tax. Paragraph (e) of this section sets forth a rule governing the interaction of section 1298(b)(7) and section 1298(a)(2). Paragraph (f) of this section sets forth anti-abuse rules for the application of section 1298(b)(7). Paragraph (g) sets forth the applicability date for this section.

(b) *Treatment of certain foreign corporations owning stock in a 25-percent-owned domestic corporation*—(1) *General rule*. Except as otherwise provided in paragraphs (e) and (f) of this section, when a tested foreign corporation (as defined in §1.1297-1(f)) is subject to the section 531 tax (or waives any benefit under any treaty that would otherwise prevent the imposition of the tax), and owns (directly or indirectly under the rules in paragraph (c) of this section) at least 25 percent (by value) of the stock of a domestic corporation (a *25-percent-owned domestic corporation*), for purposes of determining whether the foreign corporation is a PFIC, any qualified stock held directly or indirectly under the rules in paragraph (c) of this section by the 25-percent-owned domestic corporation is treated as an asset that does not produce passive income (and is not held for the production of passive income), and any amount included in gross income with respect to the qualified stock is not treated as passive income.

(2) *Qualified stock*. For purposes of paragraph (b)(1) of this section, the term *qualified stock* means any stock in a C corporation that is a domestic corporation and that is not a regulated investment company or real estate investment trust.

(c) *Indirect ownership of stock through a partnership*. For purposes of paragraph (b)(1) of this section, a tested foreign corporation that is a partner in a partnership is considered to own its proportionate share of any stock of a domestic corporation held by the partnership, and a domestic corporation that is a partner in a partnership is considered to own its proportionate share of any qualified stock held by the partnership. The rules and principles of sections 701 through 761 apply to determine the corporation's proportionate share of the stock of the domestic corporation or of the qualified stock. An upper-tier partnership's attributable share of the stock of a domestic corporation or of qualified stock held by a lower-tier partnership is treated as held by the upper-tier partnership for purposes of applying the rule in this paragraph (c).

(d) *Section 531 tax*—(1) *Subject to section 531 tax*. For purposes of paragraph (b) of this section, a tested foreign corporation is considered subject to the section 531 tax regardless of whether the tax is imposed on the corporation and of whether the requirements of §1.532-1(c) are met.

(2) *Waiver of treaty benefits*—(i) *Tested foreign corporation that files, or is required to file, a Federal income tax return*. For purposes of paragraph (b) of this section, a tested foreign corporation that files, or is required to file, a Federal income tax return waives the benefit under a treaty that would otherwise prevent the imposition of the section 531 tax by attaching to its original or amended return for the taxable year for which section 1298(b)(7) and paragraph (b)(1) of this section are applied or any prior taxable year a statement that it irrevocably waives treaty protection against the imposition of the section 531 tax, effective for all prior, current, and future taxable years, provided the taxable year for which the return is filed and all subsequent taxable years are not closed by the period of limitations on assessments under section 6501.

(ii) *Tested foreign corporation that is not required to file a Federal income tax return*. For purposes of paragraph (b) of this section, a tested foreign corporation that is not required to file a Federal income tax return waives the benefit under a treaty that would otherwise prevent the imposition of the section 531 tax by a date no later than nine months following the close of the taxable year for which section 1298(b)(7) and paragraph (b)(1) of this section are applied by—

(A) Adopting a resolution or similar governance document that confirms that it has irrevocably waived any treaty protection against the imposition of the section

531 tax, effective for all prior, current, and future taxable years, and maintaining a copy of the resolution (or other governance document) in its records; or

(B) In the case of a tested foreign corporation described in section 1297(e)(3), including in its public filings a statement that it irrevocably waives treaty protection against the imposition of the section 531 tax, effective for all prior, current, and future taxable years.

(e) *Interaction of section 1298(b)(7) and section 1298(a)(2)*. Section 1298(b)(7) does not apply to determine whether a tested foreign corporation is a PFIC for purposes of section 1298(a)(2) and §1.1291-1(b)(8)(ii).

(f) *Anti-abuse rules*—(1) *Classification as PFIC excluding qualified stock*. Paragraph (b) of this section does not apply when—

(i) 75 percent or more of the gross income of the tested foreign corporation for the taxable year (taking into account §1.1297-2 and excluding any amount included in gross income with respect to qualified stock) is passive income (as defined in §1.1297-1(c)(1)); or

(ii) The average percentage of assets held by the tested foreign corporation (taking into account §1.1297-2 and excluding qualified stock) that are passive assets (as defined in §1.1297-1(f)) is at least 50 percent.

(2) *Avoidance principal purpose*. Paragraph (b) of this section does not apply when a principal purpose for the tested foreign corporation's formation or acquisition of the stock of the 25-percent-owned domestic corporation that holds the qualified stock is to avoid classification of the tested foreign corporation as a PFIC. A principal purpose to avoid classification of the tested foreign corporation as a PFIC is deemed to exist when the 25-percent-owned domestic corporation is not engaged in an active trade or business in the United States. The existence of an active trade or business is determined under §1.367(a)-2(d)(2) and (3), except that officers and employees of the 25-percent-owned domestic corporation do not include the officers and employees of related entities as provided in §1.367(a)-2(d)(3). However, activities performed by the officers and staff of employees of a look-through subsidiary of the 25-percent-owned domestic corporation or a partnership that would be taken into account by the corporation pursuant to §1.1297-2(e) if it applied are taken into account for purposes of the determination of the existence of an active trade or business.

(g) *Applicability date*. The rules of this section apply to taxable years of shareholders beginning on or after the date of publication of the Treasury decision adopting these rules as final regulations in the **Federal Register**.

Kirsten Wielobob,
Deputy Commissioner for Services and Enforcement

Section 199A Rules for Cooperatives and their Patrons

REG-118425-18

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking; withdrawal of notice of proposed rulemaking.

SUMMARY: These proposed regulations provide guidance to cooperatives to which sections 1381 through 1388 of the Internal Revenue Code (Code) apply (Cooperatives) and their patrons regarding the deduction for qualified business income (QBI) under section 199A(a) of the Code as well as guidance to specified agricultural or horticultural cooperatives (Specified Cooperatives) and their patrons regarding the deduction for domestic production activities under section 199A(g) of the Code. These proposed regulations also provide guidance on section 199A(b)(7), the rule requiring patrons of Specified Cooperatives to reduce their deduction for QBI under section 199A(a). In addition, these proposed regulations include a single definition of *patronage and nonpatronage* under section 1388 of the Code. Finally, these proposed regulations propose to remove the final regulations, and withdraw the proposed regulations that have not been finalized, under former section 199. These proposed regulations affect Cooperatives as well as patrons that are individuals, partnerships, S corporations, trusts, and estates engaged in domestic trades or businesses.

DATES: Written (including electronic) comments and requests for a public hearing must be received by August 19, 2019. As of June 19, 2019, the proposed rule published on August 27, 2015 (80 FR 51978), is withdrawn.

ADDRESSES: Submit electronic submissions via the Federal eRulemaking Portal at *www.regulations.gov* (indicate IRS and REG-118425-18) by following the online instructions for submitting comments. Once submitted to the Federal eRulemaking Portal, comments cannot be edited or withdrawn. The Department of the Treasury (Treasury Department) and the IRS will publish for public availability any comment received to its public docket, whether submitted electronically or in hard copy. Send hard copy submissions to: CC:PA:LPD:PR (REG-118425-18), Room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, D.C., 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG-118425-18.), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, N.W., Washington, D.C., 20224.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, James Holmes at (202) 317-4137; concerning submissions of comments and requests for hearing, Regina L. Johnson at (202) 317-6901 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed amendments to the Income Tax Regulations (26 CFR part 1) under sections 199A and 1388 of the Code.

Section 199A was enacted on December 22, 2017, by section 11011 of "An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018," Public Law 115-97, 131 Stat. 2054, 2063 (TCJA). Parts of section 199A were amended on March 23, 2018, as if included in TCJA, by section 101 of Division T of the Consolidated Appropriations Act, 2018, Public Law 115-141, 132 Stat. 348, 1151 (2018 Act). Section 199A applies to taxable years beginning after 2017 and before 2026. Unless otherwise indicated, all references to section 199A are to section 199A as amended by the 2018 Act.

In addition, section 13305 of the TCJA repealed section 199 (former section 199), which provided a deduction for income attributable to domestic production activities (section 199 deduction). Public Law 115-97, 131 Stat. 2054, 2126. The repeal of former section 199 is effective for all taxable years beginning after 2017. This notice of proposed rulemaking therefore proposes to remove the final regulations under former section 199, and withdraws proposed regulations under former section 199.

Section 199A(a) provides taxpayers a deduction of up to 20 percent of QBI from a domestic business operated as a sole proprietorship or through a partnership, S corporation, trust, or estate, and up to 20 percent of qualified real estate investment trust (REIT) dividends and publicly traded partnership (PTP) income (section 199A(a) deduction). Section 199A(b)(7) requires patrons of Specified Cooperatives to reduce their section 199A(a) deduction if those patrons receive certain payments from such cooperatives. Section 199A(g) provides a deduction for Specified Cooperatives and their patrons (section 199A(g) deduction) that is based on the former section 199 deduction. Before the amendments of the 2018 Act, section 199A(g) provided a modified version of the section 199A(a) deduction for Specified Cooperatives.

The Treasury Department and the IRS published proposed regulations (REG-107892-18) providing guidance on the section 199A(a) deduction in the *Federal Register* (83 FR 40884) on August 16, 2018 (August 2018 NPRM). The final regulations were published in the *Federal Register* (84 FR 2952) on February 8, 2019 (TD 9847).

TD 9847 did not address patrons' treatment of payments received from Cooperatives for purposes of section 199A(a) or the section 199A(g) deduction for Specified Cooperatives, though it did restate the reduction required under section 199A(b)(7). *See* §1.199A-1(e)(7). The August 2018 NPRM preamble stated that the Treasury Department and the IRS would continue to study the area and intended to issue separate proposed regulations describing rules for applying section 199A to Specified Cooperatives and their patrons. This notice of proposed rulemaking sets forth those proposed regulations and provides additional guidance to patrons calculating their 199A(a) deduction.

Explanation of Provisions

The purpose of these proposed regulations is to provide guidance regarding the application of sections 199A(a), 199A(b)(7), and 199A(g) to Cooperatives and their patrons as well as to Specified Cooperatives and their patrons. Whereas section 199A(a) is generally available to patrons of all Cooperatives, sections 199A(b)(7) and 199A(g) apply only to Specified Cooperatives and their patrons.

These proposed regulations are organized into six sections: proposed §§1.199A-7 through 1.199A-12. Proposed §1.199A-7 describes rules for patrons of Cooperatives to calculate their section 199A(a) deduction and rules for patrons of Specified Cooperatives to calculate the reduction to their section 199A(a) deduction as required by section 199A(b)(7). Unless otherwise provided in these proposed regulations, all of the rules set forth in TD 9847 relating to the section 199A(a) deduction apply to Cooperatives and their patrons. Specified Cooperatives are a subset of Cooperatives; therefore, the requirements of proposed §1.199A-7 also apply to Specified Cooperatives.

Proposed §1.199A-8 sets out the criteria that Specified Cooperatives must satisfy to qualify for the section 199A(g) deduction, and sets forth four steps necessary to calculate this deduction. These proposed regulations provide that the section 199A(g) deduction available to Specified Cooperatives and their patrons is generally computed only with respect to patronage gross receipts and related deductions. Exempt Specified Cooperatives (those that qualify under section 521) may compute their section 199A(g) deductions with respect to both patronage and nonpatronage gross receipts and related deductions.

Proposed §§1.199A-9 through 1.199A-11 provide additional guidance, based on the regulations under former section 199, regarding the four steps set forth in proposed §1.199A-8. Proposed §1.199A-9 provides additional rules for determining a Specified Cooperative's domestic production gross receipts (DPGR). Proposed §1.199A-10 provides additional rules for calculating costs (including cost of goods sold (COGS) and other expenses, losses, and deductions) allocable to a Specified Cooperative's DPGR. Proposed §1.199A-11 provides additional rules for determining the W-2 wage limitation in section 199A(g)(1)(B). Proposed §1.199A-12 details rules for applying section 199A(g) in the context of an expanded affiliated group (EAG) and other special rules contained in section 199A(g)(5) that are not otherwise addressed in these proposed regulations.

These proposed regulations also include, under section 1388, a single definition of *patronage and nonpatronage* in proposed §1.1388-1(f), which is intended to reflect the current case law under section 1388. This Explanation of Provisions describes each section of the proposed regulations in more detail.

I. *Proposed §1.199A-7, Rules for Patrons of Cooperatives*

A. *In General*

As noted in the Background, section 199A(a) may allow a taxpayer a deduction of up to 20 percent of QBI from a domestic business operated as a sole proprietorship or through a partnership, S corporation, trust, or estate, and up to 20 percent of qualified REIT dividends and PTP income. A section 199A(a) deduction is not available for wage income or for business income earned through a C corporation.

C corporations are not eligible for the section 199A(a) deduction. Cooperatives are C corporations for Federal income tax purposes and, therefore, are not eligible for the section 199A(a) deduction. Similarly, patrons that are C corporations are also not eligible for the section 199A(a) deduction. However, patrons that are individuals are eligible for the section 199A(a) deduction. Section 1.199A-1(a)(2) provides that, for purposes of applying the rules of §§1.199A-1 through 1.199A-6, a reference to an individual includes a reference to a trust (other than a grantor trust) or an estate to the extent that the section 199A(a) deduction is determined by the trust or estate under the rules of §1.199A-6. These proposed regulations apply this same usage of the term *individual*.

The benefits of section 199A(a) are limited to individuals with income from a trade or business as defined in section 199A(d)(1) and §1.199A-1(b)(14) (trade or business) with QBI. To the extent a patron operating a trade or business has income directly from that business (as opposed to receiving a patronage dividend from a Cooperative), the patron must follow the rules of §§1.199A-1 through 1.199A-6 to calculate the section 199A deduction. However, to the extent a patron receives patronage dividends or similar payments from a Cooperative, the patron must follow the additional special rules and clarification in proposed §1.199A-7 to calculate the section 199A deduction.

For these purposes, 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 section 1382(b), and nonpatronage 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 section 1382(c)(2) (hereinafter collectively referred to as patronage dividends or similar payments).

Section 1.199A-7(c) and (d) of these proposed regulations provide that these patronage dividends or similar payments may be included in the patron's QBI: (i) To the extent that these payments are related to the patron's trade or business, (ii) are qualified items of income, gain, deduction, or loss at the Cooperative's trade or business level, (iii) are not income from a specified service trade or business (SSTB), as defined in section 199A(d)(2), at the Cooperative's trade or business level (except as permitted by the threshold rules, *see* §1.199A-5(a)(2)), and (iv) provided the patron receives certain information from the Cooperative about these payments (see proposed §1.199A-7(c)(3) and (d)(3)). Proposed §1.199A-7(e) provides that in situations in which a patron conducts a trade or business that receives patronage dividends or similar payments from a Cooperative, the W-2 wages and unadjusted basis immediately after acquisition (UBIA) of qualified property considered are those of the patron's trade or business and not of the Cooperative that directly conducts the trade or business from which the payments arise. All of these proposed rules are discussed further in this section.

B. *QBI of Patrons*

Although Cooperatives are C corporations for Federal income tax purposes, section 1382(b) and (c) allow Cooperatives to determine taxable income after deducting distributions of patronage dividends or similar payments to patrons. The effect of these deductions is to remove the distributions from income taxed at the Cooperative level leaving it subject to income tax only at the patron level. Exempt and nonexempt Cooperatives are both permitted to deduct patronage distributions if they satisfy the requirements described in section 1382(b). Only exempt Cooperatives are permitted to also deduct nonpatronage distributions if the requirements under section 1382(c) are met. Cooperatives are subject to Federal income tax on income for which no deduction may be taken under section 1382(b) or (c), in the same manner as any C corporation.

Section 1.199A-3(b) contains the general rules regarding QBI. QBI is the net amount of qualified items of income, gain, deduction, and loss with respect to any trade or business as determined under those rules. While income from the ownership of a C corporation is generally not QBI, section 199A provides a special rule for patrons receiving patronage dividends from a Cooperative.

Section 199A(c)(3)(B)(ii) provides that any amount described in section 1385(a)(1), which concerns patronage dividends, is not treated as an exclusion to a patron's QBI. The Joint Committee on Taxation Report (JCX-6-18, released March 22, 2018) (Joint Committee Report) states that QBI includes any patronage dividend (as defined in section 1388(a)), per-unit retain allocation (as defined in section 1388(f)), qualified written notice of allocation (as defined in section 1388(c)), or any other similar amount received from a Cooperative, provided such amount is otherwise a qualified item of income, gain, deduction, or loss (that is, such amount is (i) effectively connected with the conduct of a trade or business within the United States, and (ii) included or allowed in determining taxable income for the taxable year). Joint Committee Report, pages 24-25. As a result, the rules of proposed §1.199A-7(c) provide that patronage dividends or similar payments (as previously discussed) are included in calculating QBI for purposes of the patrons' section 199A(a) deduction provided the amounts are otherwise qualified items. To be otherwise qualified, these amounts must be qualified items of income, gain, deduction, and loss under section 199A(c)(3).

Unlike nonexempt Cooperatives, exempt Cooperatives are permitted to deduct nonpatronage distributions under section 1382(c). As a result, this income is subject to taxation only at the patron level. The rules of proposed §1.199A-7(c) provide that a patron's QBI can include payments to patrons for which the exempt Cooperative receives a deduction under section 1382(c)(2) in addition to payments for which the exempt Cooperative receives a deduction under section 1382(b). That is, amounts paid under section 1382(c)(2) are treated by a patron as equivalent to patronage dividends under section 1382(b) for purposes of QBI. Amounts paid under section 1382(c)(1) (dividends on capital stock), however, are dividends from ownership of C corporations, which are not included in QBI.

TD 9847 generally provides that income is tested at the trade or business level where it is directly generated. Accordingly, these proposed regulations provide that patronage dividends or similar payments are considered to be generated from the trade or business the Cooperative conducts on behalf of or with the patron, and are tested by the Cooperative at its trade or business level.

A patron must determine QBI for each trade or business it directly conducts. However, in situations where the patron receives a distribution from a Cooperative that is a patronage dividend or similar payment, the Cooperative determines whether that distribution contains qualified items of income, as defined under section §1.199A-3(b) , and reports that information to the patron. The patron needs this information to determine its section 199A(a) deduction, and the Cooperative directly conducting the trade or business from which the distribution is derived is in the best position to know whether the patronage dividend or similar payment contains qualified items. The Cooperative must report this information regardless of whether the patron's taxable income does not exceed the threshold amount ($315,000 in the case of joint returns and $157,500 for all other taxpayers for any taxable year beginning before 2019). For taxable years beginning after 2018, *see* Rev. Proc. 2018-57, 2018-49 IRB 827, or its successor (relating to inflation adjustments).

A patron must use that information when determining the patron's section 199A(a) deduction. For example, if the Cooperative determines an entire distribution does not contain any qualified item of income, gain, deduction, and loss because it is not effectively connected with the conduct of the Cooperative's trade or business within the United States, the Cooperative does not include such amount when reporting qualified items to the patron, and the patron does not include the distribution in the patron's QBI. In addition, to the extent the distribution includes interest income that is not properly allocable to the Cooperative's trade or business on behalf of, or with, its patrons, the distribution is not a qualified item of income, gain, deduction, and loss. As a result, the Cooperative does not include such amount when reporting qualified items to the patron, and the patron does not include the income in the patron's QBI.

Proposed §1.199A-7(c)(3) provides that the Cooperative must report the amount of qualified items of income, gain, deduction, or loss in the distributions made to the patron on an attachment to or on the Form 1099-PATR, Taxable Distributions Received From Cooperatives (Form 1099-PATR) (or any successor form), issued by the Cooperative to the patron, unless otherwise provided by the instructions to the Form. The Cooperative does not include any items from an SSTB in reporting the amount of qualified items of income, gain, deduction, and loss and must instead follow the rules in proposed §1.199A-7(d) for income from an SSTB. If a patron does not receive such 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. This presumption 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 attachment thereto before the publication of these proposed regulations in the *Federal Register*. These rules apply to both exempt and nonexempt Cooperatives as well as patronage and nonpatronage distributions. The Treasury Department and the IRS request comments on these reporting requirements and whether any additional information from Cooperatives that make distributions to their patrons is needed for their patrons to determine their section 199A(a) deduction.

C. *Specified Service Trade or Business*

Section 199A(c)(1) provides that only items attributable to a qualified trade or business are taken into account in determining the section 199A(a) deduction for QBI. Under section 199A(d)(1) a "qualified trade or business" excludes (A) an SSTB or (B) the trade or business of performing services as an employee. TD 9847 provides that, unless an exception applies, if a trade or business is an SSTB, none of its items are to be taken into account for purposes of determining a taxpayer's QBI.

Under section 199A(d)(3), individuals with taxable income not exceeding the threshold amount ($315,000 in the case of joint returns and $157,500 for all other taxpayers for any taxable year beginning before 2019), are not subject to a restriction with respect to SSTBs. For taxable years beginning after 2018, *see* Rev. Proc. 2018-57, 2018-49 IRB 827, or its successor. Therefore, if an individual has taxable income not exceeding the threshold amount, the individual is eligible for the section 199A(a) deduction with respect to qualified items of income, gain, deduction, and loss from the SSTB notwithstanding that the trade or business is an SSTB. The inapplicability of the SSTB rules, W-2 wage limitation, and UBIA of qualified property limitation in computing the section 199A(a) deduction is subject to a phase-in for individuals with taxable income within the phase-in range. *See* the rules in §1.199A-5 for the rules relating to SSTBs.

The rules in proposed §1.199A-7(d) clarify that a patron (whether the patron is a relevant passthrough entity (RPE) or an individual) must determine whether the trades or businesses it directly conducts are SSTBs. These proposed rules also provide that in the case of a patron's trade or business that receives patronage dividends or similar payments distributed from a Cooperative, the Cooperative must determine whether the distributions from the Cooperative include items of income, gain, deduction, and loss from an SSTB directly conducted by the Cooperative, and whether such items are qualified items with respect to such SSTB. The Cooperative must report to the patron the amount of qualified items of income, gain, deduction, and loss from an SSTB directly conducted by the Cooperative. The patron then determines if the distribution may be included in the patron's QBI depending on the patron's taxable income and the statutory phase-in and threshold amounts. Because the Cooperative may not know whether the patron's taxable income exceeds the threshold amount, the Cooperative must report this information to all patrons. Without this information, a patron with taxable income within the phase-in range or below the threshold amount would not have the information necessary to take into account the amount of qualified items of income, gain, deduction, and loss from an SSTB in determining the patron's section 199A(a) deduction for QBI. The rules in §1.199A-5 are applied by the Cooperative to determine if the trade or business is an SSTB. For example, the Cooperative will apply the gross receipts de minimis rules in §1.199A-5(c)(1) to determine if the trade or business is an SSTB.

Proposed §1.199A-7(d)(3) provides that the Cooperative must report to the patron the amount of SSTB income, gain, deduction, and loss in distributions that is qualified with respect to any SSTB directly conducted by the Cooperative on an attachment to or on the Form 1099-PATR (or any successor form) issued by the Cooperative to the patron, unless otherwise provided by the instructions to the Form. If the Cooperative does not report the amount on or before the due date of the Form 1099-PATR, then only the amount that a Cooperative reports as qualified items of income, gain, deduction, and loss under §1.199A-7(c)(3) may be included in the patron's QBI, and the remaining amount of distributions from the Cooperative that may be included in the patron's QBI is presumed to be zero. This presumption 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 attachment thereto before the publication of these proposed regulations in the *Federal Register*. These rules apply to both exempt and nonexempt Cooperatives as well as to patronage and nonpatronage distributions. The Treasury Department and the IRS request comments on these reporting requirements and whether any additional information from Cooperatives that make distributions to their patrons is needed for their patrons to determine their section 199A(a) deduction.

D. *Determination of W-2 Wages and UBIA of Qualified Property*

Section §1.199A-1(d) addresses the calculation of the section 199A(a) deduction for individuals with taxable income exceeding the threshold amount and provides guidance on the application of these limitations. All of the rules relating to the REIT dividends and qualified PTP income component of the section 199A(a) deduction applicable to individuals with taxable income not exceeding the threshold amount also apply to individuals with taxable income exceeding the threshold amount. The QBI component of the section 199A(a) deduction, however, is subject to limitations for individuals with taxable income exceeding the threshold amount. These include the limitations based on the W-2 wages of the trade or business or a combination of the W-2 wages and the UBIA of qualified property.

Under §1.199A-2, W-2 wages and UBIA of qualified property are determined by the individual or RPE that directly conducts the trade or business. Section 199A(f)(1)(A)(2)(iii) requires that S corporations and partnerships allocate W-2 wages and UBIA of qualified property to their owners in accordance with each owner's applicable share, and §1.199A-6 contains additional information regarding these reporting requirements. Section 199A does not provide a similar rule for Cooperatives.

Section 199A(c)(3)(B)(ii) provides that patronage dividends or similar payments may be treated as qualified items of income. Only the Cooperative knows the origin and character of the patronage dividends or similar payments. As a result, the Cooperative must determine if these payments meet the statutory requirements in section 199A(c)(3), and must provide information to the patron for it to compute its section 199A(a) deduction. In contrast, section 199A contains special rules for W-2 wages and UBIA of qualified property. To provide that Cooperatives allocate their W-2 wages and UBIA of qualified property to their patrons would be to treat the Cooperatives as RPEs when they are C corporations. Therefore, the rules in proposed §1.199A-7(e) provide that patrons directly conducting trades or businesses that receive patronage dividends or similar payments from a Cooperative calculate the W-2 wage and UBIA of qualified property limitations at the patron level based on the patrons' trades or businesses, without any regard to the Cooperative's W-2 wages or UBIA of qualified property.

In summary, a Cooperative must report to patrons: (i) Whether the patronage dividends or similar payments include qualified items of income, gain, deduction, and loss from a non-SSTB and (ii) whether the distributions from the Cooperative include qualified items of income, gain, deduction, and loss from an SSTB directly conducted by the Cooperative, but a Cooperative does not report any W-2 wages or UBIA of qualified property to patrons. The Treasury Department and the IRS request comments on these proposed rules regarding W-2 wages and UBIA of qualified property and whether it would be appropriate for Cooperatives to be required to report such amounts to patrons to determine their section 199A(a) deduction.

E. *Special Rules for Patrons of Specified Cooperatives*

Section 199A provides special rules for patrons of Specified Cooperatives. Because patrons of Specified Cooperatives may be eligible to take both a section 199A(a) and section 199A(g) deduction, section 199A(b)(7) provides that if a trade or business of a patron of a Specified Cooperative receives qualified payments (as defined in section 199A(g)(2)(e) and proposed §1.199A-8(d)(2)(ii)) from such Specified Cooperative that are included in the patron's QBI, the patron must reduce its section 199A(a) deduction by the lesser of (i) 9 percent of so much of the QBI with respect to such trade or business that is properly allocable to qualified payments from the Specified Cooperative, or (ii) 50 percent of so much of the patrons' W-2 wages (determined under section 199A(b)(4)) with respect to such trade or business as are so allocable. This reduction is required by section 199A(b)(7) whether the Specified Cooperative passes through all, some, or none of the Specified Cooperative's section 199A(g) deduction to the patron in that taxable year.

Section 1.199A-3(b)(5) provides an allocation method for items of QBI attributable to more than one trade or business. That allocation method also applies to patrons with multiple trades or businesses. The rules in proposed §1.199A-7(f)(2) provide an additional similar allocation method in situations where a patron receives qualified payments and income that is not a qualified payment in a trade or business. The patron must allocate those items using a reasonable method based on all the facts and circumstances. Different reasonable methods may be used for different items of income, gain, deduction, and loss. The chosen reasonable method for each item must be consistently applied from one taxable year to another and must clearly reflect the income and expenses of each trade or business. The overall combination of methods must also be reasonably based on all the facts and circumstances. The books and records maintained for a trade or business must be consistent with any allocations. The Treasury Department and the IRS are open to considering whether a permissible "reasonable method" should be specified in regulations or permitted to include methods based on direct tracing, allocations based on gross income, or other methods, within appropriate parameters. The Treasury Department and the IRS request comments on possible reasonable methods for the allocation of items not clearly attributable to a single trade or business, and whether any safe harbors may be appropriate.

Because the section 199A(b)(7) reduction applies to the portion of a patron's QBI that relates to qualified payments from a Specified Cooperative, these proposed rules provide a safe harbor allocation method for patrons with taxable income not exceeding the threshold amounts set forth in section 199A(e)(2) to determine how to calculate the section 199A(b)(7) reduction. The safe harbor allocation method is intended to provide a straightforward method for patrons if their trade or business receives qualified payments from a Specified Cooperative in addition to other income. To calculate the required section 199A(b)(7) reduction, the patron must allocate the aggregate business expenses and W-2 wages between qualified payments and other gross receipts. The safe harbor allocation method allows patrons to allocate by ratably apportioning business expenses and W-2 wages based on the proportion that the amount of qualified payments bears to the total gross receipts used to determine QBI. The Treasury Department and the IRS request comments on this safe harbor rule and whether there are additional or alternative safe harbors that may be appropriate.

Further, to make the calculation required by section 199A(b)(7), the patron will need to know the qualified payments allocable to the patron that were used in calculating a Specified Cooperative's section 199A(g) deduction. In order to enable the patron to make this calculation, proposed §1.199A-7(f)(3) requires the Specified Cooperative to report the amount of such qualified payments on an attachment to or on the Form 1099-PATR, (or any successor form) issued by the Cooperative to the patron, unless otherwise provided by the instructions to the Form.

F. *Transition Rule*

Congress provided a special transition rule relating to qualified payments under former section 199 made by Specified Cooperatives in section 101 of the 2018 Act. Under this transition rule, the repeal of former section 199 for taxable years beginning after December 31, 2017, does not apply to former section 199 qualified payments received by a patron from Specified Cooperatives in a taxable year beginning after December 31, 2017, to the extent such qualified payments are attributable to qualified production activities income (QPAI) with respect to which a deduction is allowable to the Specified Cooperatives under former section 199 for a taxable year of the Specified Cooperatives beginning before January 1, 2018. Such qualified payments remain subject to former section 199, and any deduction under former section 199 allocated by the Specified Cooperatives to their patrons related to such qualified payments may be deducted by such patrons in accordance with former section 199. In addition, no deduction is allowed under section 199A(a) and (g) with respect to such qualified payments. *See* Pub. L. 115–97, title I, §13305(c), Dec. 22, 2017, 131 Stat. 2054, 2126 (codified as amended at I.R.C. §74 Note), as amended by Pub. L. 115–141, div. T, §101(c), Mar. 23, 2018, 132 Stat. 348, 1151, providing a transitional rule for qualified payments of patrons of Cooperatives.

Proposed §1.199A-7(h)(3) and §1.199A-8(h)(3) provide that the Cooperative must identify in a written notice to its patrons that a section 199A(a) deduction cannot be claimed for qualified payments that otherwise would constitute QBI in the patron's trade or business in a taxable year in which the qualified payments remain subject to former section 199. The Cooperative must report this information on an attachment to or on the Form 1099-PATR (or any successor form) issued by the Cooperative to the patron, unless otherwise provided by the instructions to the Form.

II. *Proposed §1.199A-8, Deduction for Income Attributable to Domestic Production Activities of Specified Cooperatives*

A. *In General*

Section 199A(g) provides a deduction for Specified Cooperatives and their patrons that is similar in many respects to the deduction under former section 199. Proposed §1.199A-8 provides definitions relating to the section 199A(g) deduction, establishes the criteria that a Specified Cooperative must satisfy to be eligible to claim the section 199A(g) deduction, and sets forth the necessary steps for a Specified Cooperative to calculate the section 199A(g) deduction.

B. *Definitions*

Proposed §1.199A-8 defines the terms *patron*, *Specified Cooperative*, and *agricultural or horticultural products*. In defining *patron*, the Treasury Department and the IRS sought consistency with the rules under subchapter T of chapter 1 of subtitle A of the Code. Thus, the rules in proposed §1.199A-8 cross-reference the definition of patron found in §1.1388-1(e).

The definition of *Specified Cooperative* is consistent with the definition set forth in section 199A(g)(4). This definition is different from the definition of *Specified Cooperative* as originally provided by section 11011(a) of the TCJA (former section 199A(g)(3)), as it no longer includes a Cooperative solely engaged in the provision of supplies, equipment, or services to farmers or other Specified Cooperatives (former section 199A(g)(3)(C)).

Proposed §1.199A-8(a)(4) defines *agricultural or horticultural products* as agricultural, horticultural, viticultural, and dairy products, livestock and the products thereof, the products of poultry and bee raising, the edible products of forestry, and any and all products raised or produced on farms and processed or manufactured products thereof within the meaning of the Cooperative Marketing Act of 1926, 44 Stat. 802 (1926). Agricultural or horticultural products also include aquatic products that are farmed whether by exempt or nonexempt Specified Cooperatives. *See* Rev. Rul. 64-246, 1964-2 C.B. 154. In addition, agricultural or horticultural products include fertilizer, diesel fuel, and other supplies used in agricultural or horticultural production that are manufactured, produced, grown, or extracted (MPGE) by the Specified Cooperative. *See* Joint Committee Report, at 23, footnote 120.

Agricultural or horticultural products do not include intangible property. For example, an agricultural or horticultural product includes a seed that is grown, but does not include an intangible property right to reproduce a seed for sale. This exclusion of intangible property does not apply to intangible characteristics of any particular agricultural or horticultural product. For example, gross receipts from the sale of different varieties of oranges would all qualify as DPGR from the disposition of agricultural or horticultural products (assuming all other requirements of section 199A(g) are met). However, gross receipts from the license of the right to produce and sell a certain variety of oranges would be considered separate from the tangible oranges themselves and therefore not gross receipts from an agricultural or horticultural product. This exclusion is consistent with former section 199, which excluded intangible property other than computer software, any property described in section 168(f)(4) (sound recordings), and qualified film products.

The Treasury Department and the IRS considered a similar but alternative definition of *agricultural or horticultural* products as agricultural, horticultural, viticultural, and dairy products, livestock and poultry, bees, forest products, fish and shellfish, and any products thereof, including processed and manufactured products, and any and all products raised or produced on farms and any processed or manufactured product thereof within the meaning of the Agricultural Marketing Act of 1946, 60 Stat. 1091 (1946). While very similar to the definition set forth in these proposed rules, the Treasury Department and the IRS proposed using the definition based on the Cooperative Marketing Act of 1926, which specifically concerns cooperatives, unlike the Agricultural Marketing Act of 1946, which concerns the marketing and distribution of agricultural products.

The Treasury Department and the IRS also considered an alternative definition of *agricultural or horticultural products* based on general regulations under the Commodity Exchange Act. The Commodity Futures Trading Commission defines *agricultural commodities* as wheat, cotton, rice, corn, oats, barley, rye, flaxseed, grain sorghums, mill feeds, butter, eggs, Solanum tuberosum (Irish potatoes), wool, wool tops, fats and oils (including lard, tallow, cottonseed oil, peanut oil, soybean oil and all other fats and oils), cottonseed meal, cottonseed, peanuts, soybeans, soybean meal, livestock, livestock products, and frozen concentrated orange juice, but not onions; other commodities that are, or once were, or are derived from, living organisms, including plant, animal and aquatic life, which are generally fungible, within their respective classes, and are used primarily for human food, shelter, animal feed or natural fiber; tobacco, products of horticulture, and such other commodities used or consumed by animals or humans. 17 CFR 1.3. The Treasury Department and the IRS concluded that this definition was too narrow, because it is limited to products that can be commodities.

The Treasury Department and the IRS are considering alternative definitions of *agricultural or horticultural products* to address concerns that the definition could be interpreted inconsistently with the ordinary meaning of agricultural or horticultural products. A clarification of the definition that is under consideration is the limitation of agricultural or horticultural products to products acquired from original producers, such as farmers, planters, ranchers, dairy farmers, or nut or fruit growers, and products thereof that are MPGE by Specified Cooperatives. The Treasury Department and the IRS request comments on whether the original producer approach being considered would be appropriate, as well as other approaches to defining agricultural or horticultural products. The Treasury Department and the IRS also request comments on the impact, if any, of the proposed definition on which products are MPGE by Specified Cooperatives.

A Specified Cooperative's gross receipts from the disposition of agricultural or horticultural products qualify as DPGR if the products were MPGE by the Specified Cooperative in whole or significant part within the United States. The proposed regulations define *in whole or significant part* for these purposes in proposed §1.199A-9(h) and provide a 20 percent safe harbor for such determination in proposed §1.199A-9(h)(3).

The definition of gross receipts in proposed §1.199A-8(b)(2)(iii) is essentially the same as in §1.199-3(c) issued under former section 199, except that this definition has been modified by removing references to section 1031 (exchange of real property held for productive use or investment) and tax-exempt interest within the meaning of section 103 (interest on State and local bonds). The reference to section 1031 is removed because that provision now applies only to real property. The section 199A(g) deduction is based on gross receipts derived from the disposition of agricultural or horticultural products and section 199A(g)(3)(D)(i) expressly excludes gross receipts derived from the disposition of land from DPGR. The reference to tax-exempt interest under section 103 is removed because it is appropriate for the definition of gross receipts to include only gross receipts that are taken into account in computing gross income under the Cooperative's methods of accounting used for Federal income tax purposes for the taxable year.

The Treasury Department and the IRS welcome comments regarding all aspects of these proposed definitions, including whether there is an alternative or more appropriate definition of *Specified Cooperative* or *agricultural or horticultural products*, and clarification of when MPGE is performed in whole or significant part in the United States that would provide greater certainty for taxpayers in complying with, and the IRS in administering, the requirements for claiming the section 199A(g) deduction. The Treasury Department and the IRS also welcome comments on the appropriateness of the 20 percent safe harbor in proposed §1.199A-9(h)(3).

C. *Steps for Calculating Section 199A(g) Deduction*

Proposed §1.199A-8 sets forth four required steps to determine the amount of a nonexempt Specified Cooperative's section 199A(g) deduction and provides rules to determine the amount of an exempt Specified Cooperative's section 199A(g) deduction.

i. *Patronage/nonpatronage Split*

The first step under the rules of proposed §1.199A-8 for calculating the section 199A(g) deduction requires nonexempt Specified Cooperatives to identify the gross receipts and related deductions (other than a deduction under section 199A(g)) that are from patronage sources and from nonpatronage sources. Specified Cooperatives must separate their patronage and nonpatronage gross receipts and related deductions when determining taxable income and allocating expenses between patronage and nonpatronage income to claim the tax deductions under section 1382(b) and (c). Cooperatives that have gross receipts only from patronage sources will be unaffected. Accordingly, the proposed regulations' requirement to divide patronage/nonpatronage gross receipts and related deductions should not significantly impact the existing allocation requirements applicable to Specified Cooperatives.

This step is expressly included in these proposed rules because proposed §1.199A-8 provides that for all purposes of the section 199A(g) deduction, nonexempt Specified Cooperatives may use only patronage gross receipts and related deductions to calculate DPGR, QPAI (including oil-related QPAI), taxable income, and the W-2 wage limitation.

Separating a nonexempt Specified Cooperative's patronage items from its nonpatronage items is consistent with the structure and intent of section 199A. Section 199A in its entirety is structured to give businesses that are not operating as C corporations a deduction that corresponds to the TCJA's reduction of the top corporate rate of tax under section 11. C corporations are expressly prohibited under section 199A(a) from claiming a section 199A(a) deduction, and under section 199A(g)(2)(D)(i) from claiming a section 199A(g) deduction. Although section 199A(g) provides a deduction for Specified Cooperatives, the statutory prohibitions preventing C corporations from benefiting under section 199A(g) (which were absent from the statutory text of former section 199) are in conflict with permitting a section 199A(g) deduction for the nonpatronage business of a nonexempt Specified Cooperative. Instead, nonpatronage source income of a nonexempt Specified Cooperative receives an alternate benefit shared by other C corporations: the TCJA's reduction of the top rate of tax under section 11 from 35 percent to 21 percent.

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

Accordingly, the Treasury Department and the IRS have determined that it is appropriate to limit the source of the gross receipts and related deductions taken into account for purposes of the section 199A(g) deduction for nonexempt Specified Cooperatives to items properly allocated to a nonexempt Specified Cooperative's patronage business. The Treasury Department and the IRS request comments regarding these proposed rules, including comments explaining any policy rationale that would justify treating the nonpatronage business of a nonexempt Specified Cooperative differently from the business operations of any other C corporation subject to the tax imposed under section 11.

ii. *Identifying Patronage DPGR*

The second step set forth in proposed §1.199A-8 is for nonexempt Specified Cooperatives to identify patronage gross receipts that qualify as DPGR. The rules in proposed §1.199A-8 point nonexempt Specified Cooperatives to proposed §1.199A-9 for additional information on DPGR. The rules in proposed §1.199A-9 do not refer to gross receipts from patronage or nonpatronage business because the rules only provide additional information supplementing the determination of DPGR from dispositions of agricultural or horticultural products. When applying §1.199A-9, which occurs after step 1 in §1.199A-8, the only gross receipts of a nonexempt Specified Cooperative considered would be those derived from patronage sources. Proposed §1.199A-9 is essentially the same as §§1.199-1 and 1.199-3 issued under former section 199, adjusted to apply to Specified Cooperatives.

iii. *Calculating Patronage QPAI*

The third step set forth in proposed §1.199A-8 is for nonexempt Specified Cooperatives to calculate QPAI (including oil-related QPAI) from only their patronage DPGR. To do this, nonexempt Specified Cooperatives must determine COGS and other expenses, losses, or deductions that are allocable to patronage DPGR. Nonexempt Specified Cooperatives are directed to consult proposed §1.199A-10 for additional information on making these allocations. Proposed §1.199A-10 does not refer to patronage or nonpatronage QPAI or DPGR because it only provides additional information supplementing the QPAI calculation. Proposed §1.199A-10 is essentially the same as §1.199-4 issued under former section 199, adjusted to apply to Specified Cooperatives.

iv. *Calculating Patronage Section 199A(g) Deduction*

The fourth and final step set forth in proposed §1.199A-8 is for nonexempt Specified Cooperatives to calculate their section 199A(g) deduction, which is equal to 9 percent of the lesser of QPAI or taxable income, and subject to the W-2 wage limitation. Nonexempt Specified Cooperatives are directed to consult proposed §1.199A-11 for additional information on the W-2 wage limitation. Proposed §1.199A-11 does not refer to patronage or nonpatronage QPAI, taxable income, or W-2 wages because it only provides additional information supplementing the W-2 wage limitation. Proposed §1.199A-11 is essentially the same as §1.199-2 issued under former section 199, adjusted to apply to Specified Cooperatives.

v. *Exempt Specified Cooperatives*

Proposed §1.199A-8(c) provides that exempt Specified Cooperatives calculate two separate section 199A(g) deductions, one based on gross receipts and related deductions from patronage sources, and one based on gross receipts and related deductions from nonpatronage sources. Like a nonexempt Specified Cooperative, an exempt Specified Cooperative earns patronage income that is not taxed to the extent of any section 1382(b) deduction for patronage distributions made to patrons. Exempt Specified Cooperatives are also not taxed on any nonpatronage income to the extent of any section 1382(c) deduction for nonpatronage distributions. Unlike the usual taxation of C corporations, the section 1382 deductions allow an exempt Specified Cooperative to be treated more like a passthrough entity by reducing the exempt Specified Cooperative's patronage and nonpatronage income. It is therefore appropriate that the exempt Specified Cooperatives may take a section 199A(g) deduction on both patronage and nonpatronage income that could be deducted under section 1382(b) and (c)(2).

As described earlier, calculating two section 199A(g) deductions is consistent with the administration of former section 199. To calculate the two section 199A(g) deductions, an exempt Specified Cooperative is required under proposed §1.199A-8 to perform steps two through four twice, first using only its patronage gross receipts and related deductions and second using only its nonpatronage gross receipts and related deductions. An exempt Specified Cooperative cannot combine, merge, or net patronage and nonpatronage items at any step in determining its patronage section 199A(g) deduction and its nonpatronage section 199A(g) deduction.

D. *Special Rule for Oil-Related QPAI*

Section 199A(g)(5)(E) contains a special rule for Specified Cooperatives with oil-related QPAI, which requires a reduction by 3 percent of the least of oil-related QPAI, QPAI, or taxable income of the Specified Cooperative for the taxable year. The language of this rule is the same as the language used in former section 199(d)(9). Former section 199(d)(9), which applied to taxable years beginning after December 31, 2008, was added by section 401(a), Division B of the Energy Extension Act of 2008, Public Law 110–343, 122 Stat. 3765 (2008). These proposed rules include rules for oil-related QPAI that are similar to those contained in proposed regulations (REG-136459-09) relating to the section 199 deduction published in the *Federal Register* (80 FR 51978) on August 27, 2015 (2015 Proposed Regulations).

The 2015 Proposed Regulations included rules related to a taxpayer's determination of oil-related QPAI (with respect to which no comments were received). Although not finalized, the 2015 Proposed Regulations are the only existing guidance concerning a taxpayer's determination of oil-related QPAI. The preamble to the 2015 Proposed Regulations includes an explanation of the reasons supporting the proposed provisions, and these reasons continue to apply. These include the determination that gross receipts from transportation and distribution of oil are not included in the calculation of oil-related QPAI, unless the gross receipts are considered DPGR under the de minimis rule or an exception for embedded services now contained in proposed §1.199A-9. Gross receipts from transportation and distribution are not included in QPAI and DPGR (unless an exception applies), and therefore it is appropriate to exclude such gross receipts when calculating oil-related QPAI.

E. *Rules for Passing Section 199A(g) Deduction to Patrons*

Once a Specified Cooperative calculates the section 199A(g) deduction, it may pass on the section 199A(g) deduction to patrons who are eligible taxpayers as defined in section 199A(g)(2)(D), that is, (i) a patron that is other than a C corporation or (ii) a patron that is a Specified Cooperative. Section 199A(g)(2)(A) requires the Specified Cooperative to identify the amount of the section 199A(g) deduction being passed to a patron in a notice (required by proposed §1.199A-8(d)(3)) mailed to the eligible patron during the payment period described in section 1382(d). The amount of the section 199A(g) deduction that a Specified Cooperative can pass through to an eligible taxpayer is limited to the portion of the section 199A(g) deduction that is allowed with respect to the QPAI to which the qualified payments made to the eligible taxpayer are attributable. Section 199A(g)(2)(E) defines qualified payments as those that are included in the eligible taxpayer's income under section 1385(a)(1) and (3) (referencing patronage dividends and per-unit retain allocations). Proposed §1.199A-8 further provides that a Specified Cooperative that receives a section 199A(g) deduction as an eligible taxpayer can take the deduction only against patronage gross income and related deductions, or pass on the deduction to its patrons that are eligible taxpayers. The proposed rules do not allow an exempt Specified Cooperative to pass through any of the section 199A(g) deduction attributable to nonpatronage activities because no QPAI is attributable to any qualified payments. The rules of proposed §1.199A-8 are essentially the same as the rules of §1.199-6, adjusted to include other provisions of the section 199 final regulations as well as proposed rules set forth in the 2015 Proposed Regulations.

F. *Cooperative as a Partner in a Partnership*

Proposed §1.199A-8(f) provides guidance regarding circumstances in which a Specified Cooperative is a partner in a partnership as described under section 199A(g)(5)(B). The proposed rules provide that the partnership must separately identify and report on the Schedule K-1 to the Form 1065, U.S. Return of Partnership Income, (or any successor form) issued to its partner, unless otherwise provided by the instructions to the Form, the Specified Cooperative's allocable share of gross receipts and related deductions. This allows the Specified Cooperative partner to apply the four steps in proposed §1.199A-8 required to calculate its patronage section 199A(g) deduction (or patronage and nonpatronage section 199A(g) deductions in the case of an exempt Specified Cooperative).

III. *Proposed §1.199A-9, Domestic Production Gross Receipts*

A. *In General*

Section 199A(g)(3)(D) defines the term *domestic production gross receipts* to mean gross receipts of a Specified Cooperative derived from any lease, rental, license, sale, exchange, or other disposition (collectively, a "disposition") of any agricultural or horticultural product which was MPGE (determined after application of section 199A(g)(4)(B)) by the Specified Cooperative in whole or significant part within the United States. Such term does not include gross receipts of the Specified Cooperative derived from a disposition of land or from services. These proposed regulations are based on §1.199-3 issued under former section 199, but remove provisions that would not apply to the disposition of agricultural or horticultural products.

DPGR includes the gross receipts that a Specified Cooperative derives from marketing agricultural or horticultural products for patrons. Section 199A(g)(4)(B) treats marketing Specified Cooperatives as having MPGE any agricultural or horticultural product in whole or significant part within the United States if their patrons have done so. The Treasury Department and the IRS considered whether this rule should apply between Specified Cooperatives and patrons taxed as C corporations. These proposed regulations allow attribution to apply as provided in section 199A(g)(4)(B) because the statute does not distinguish between types of patrons. However, these proposed regulations do not allow a Specified Cooperative to pass through to a C corporation any of the section 199A(g) deduction of the Specified Cooperative attributable to the disposition of such agricultural or horticultural products. This is because, under section 199A(g)(2)(D), taxpayers taxed as C corporations are not eligible to claim a section 199A(g) deduction from the Specified Cooperative. These proposed regulations incorporate the rules from §1.199-1(d)(1) through (3) and (e), issued under former section 199, as applicable. These rules relate to the allocation of gross receipts between DPGR and non-DPGR, and the determination of whether an allocation method is reasonable. Further, the rules include provisions permitting Specified Cooperatives to treat de minimis gross receipts as DPGR or non-DPGR without allocating such gross receipts, and a provision permitting the use of historical data to allocate gross receipts for certain multiple-year transactions. The Treasury Department and the IRS welcome comments regarding all aspects of these proposed rules. When incorporating these concepts from the former section 199 regulations, the Treasury Department and the IRS determined that the appropriate section of these proposed regulations in which to include such guidance was proposed §1.199A-9. This is not a substantive change, but rather a reorganization to improve clarity.

B. *Definition of Manufactured, Produced, Grown, Extracted*

The definition of the term *MPGE* is included in proposed §1.199A-9 and is generally consistent with the definition in §1.199-3(e)(1). However, these proposed regulations revise the rule in §1.199-3(e)(2) by removing the concept of minor assembly. In the 2015 Proposed Regulations, the Treasury Department and the IRS requested comments on defining the term *minor assembly* because of the difficulty in identifying a widely applicable objective test. Based on the comments received and the restriction on the section 199A(g) deduction to agricultural or horticultural products, proposed §1.199A-9 does not include the term *minor assembly* included in §1.199-3(e)(2). This exclusion does not impact a taxpayer's obligation to meet all of the other requirements to qualify for the section 199A(g) deduction. The Treasury Department and the IRS request comments on whether the concept of minor assembly should be retained and, if so, how this term should be defined.

C. *By the Taxpayer*

With respect to the phrase "by the taxpayer" as used in section 199A(g)(3)(D)(i), these proposed regulations adopt the rule from §1.199-3(f)(1) as applicable, rather than the rule in the 2015 Proposed Regulations. In a contract manufacturing arrangement, this means that a Specified Cooperative must have the benefits and burdens of ownership of the agricultural or horticultural product during the period in which the MPGE activity occurs in order for the Specified Cooperative to be treated as engaging in such MPGE activity. The 2015 Proposed Regulations provided a different rule for contract manufacturing arrangements. The 2015 Proposed Regulations provided that if a qualifying activity is performed under a contract, then the party that performs the qualifying activity is the taxpayer for purposes of section 199(c)(4)(A)(i). Under the rule in the 2015 Proposed Regulations, a Specified Cooperative that contracts with another party for the MPGE of an agricultural or horticultural product would never qualify as "the taxpayer" for purposes of the section 199A(g) deduction. This result fails to provide any incentive for Specified Cooperatives to retain the benefits and burdens of ownership and to ensure that production occurs within the United States. Therefore, to maintain such an incentive, the proposed regulations maintain the rule from §1.199-3(f)(1). The Treasury Department and the IRS request comments on the continued use of the rule from §1.199-3(f)(1).

D. *Other Provisions in Proposed §1.199A-9*

The remainder of the rules in proposed §1.199A-9 are based on the existing regulations in §1.199-3. These rules should be interpreted in a manner consistent with the interpretation under former section 199. The Treasury Department and the IRS request comments on any conception or definition that in application would be over or under-inclusive under the proposed regulations, or any instances where they should interpret the rules differently from the interpretation under former section 199.

IV. *Proposed §1.199A-10, Costs Allocable to DPGR*

Proposed §1.199A-10 provides guidance on the allocation of costs to DPGR.

This section provides rules for allocating a taxpayer's COGS, as well as other expenses, losses, and deductions properly allocable to DPGR. These proposed regulations are based on and follow the section 199 regulations in §1.199-4.

V. *Proposed §1.199A-11, Wage Limitation*

Proposed §1.199A-11 provides guidance regarding the W-2 wage limitation on the section 199A(g) deduction. A notice of proposed revenue procedure, Notice 2019-27, 2019-31 IRB, which proposes a draft revenue procedure providing three proposed methods that Specified Cooperatives may use for calculating W-2 wages, is being issued concurrently with this notice of proposed rulemaking. The guidance contained in the notice of proposed revenue procedure is necessary because changes may be made to the underlying Form W-2, Wage and Tax Statement, on a more frequent basis than updates to the regulations under section 199A(g), for regulatory and statutory reasons independent of section 199A. The three proposed methods for calculating W-2 wages in the notice are substantially similar to the methods provided in Rev. Proc. 2006-47, 2006-2 C.B. 869 (relating to the section 199 deduction), and Rev. Proc. 2019-11, 2019-09 IRB 742 (relating to the section 199A(a) deduction). The Treasury Department and the IRS propose these methods in a notice of proposed revenue procedure rather than in the notice of proposed rulemaking to maintain consistency with the rules under former section 199 and the rules under section 199A. The notice of proposed revenue procedure invites comments from the public.

Under the proposed regulations, W-2 wages for the purpose of the wage limitation in section 199A(g) are generally determined in a manner that is similar to the manner in which W-2 wages are determined for the purpose of the deduction under section 199A(a) (that is, using the definition of W-2 wages under section 199A(b)(4)), with three significant differences. First, section 199A(g)(1)(B)(ii) provides that W-2 wages are determined without regard to section 199A(b)(4)(B), which excludes from the definition amounts not properly allocable to QBI for purposes of section 199A(c)(1). Second, W-2 wages under section 199A(g) do not include any amount that is not properly allocable to DPGR. Finally, W-2 wages under section 199A(g) do not generally include any remuneration paid for services in the commonwealth of Puerto Rico and other United States territories. Specifically, section 199A(g)(1)(B)(ii) provides that W-2 wages are determined in the same manner as under section 199A(b)(4), and section 199A(b)(4)(A) defines wages as amounts described in section 6051(a)(3) and (8). The amounts described in section 6051(a)(3) are "wages as defined in section 3401(a)." Section 3401(a)(8) generally excludes from the definition of wages in section 3401(a) wages paid with respect to employment in the commonwealth of Puerto Rico and other United States territories. Therefore, wages paid with respect to employment in the commonwealth of Puerto Rico and other United States territories are generally not W-2 wages within the meaning of section 199A(b)(4)(A). This contrasts with the section 199A(a) deduction for which section 199A(f)(1)(C)(ii) allows certain taxpayers with QBI from sources within the commonwealth of Puerto Rico (section 199A(f)(1)(C)(ii) applies only to Puerto Rico and not to other United States territories) to compute section 199A(b)(4) W-2 wages without regard to section 3401(a)(8). Since the section 199A(g) deduction is determined based on QPAI, not QBI, section 199A(f)(1)(C)(ii) does not apply to the deduction under section 199A(g). Given the distinction between QBI and QPAI on which the section 199A(a) and section 199A(g) deductions are respectively provided, and the absence of a provision similar to 199A(f)(1)(C)(ii) with respect to QPAI, the Treasury Department and the IRS have determined that remuneration paid with respect to employment in the commonwealth of Puerto Rico cannot be used in determining W-2 wages for purposes of section 199A(g). The Treasury Department and the IRS request comments with respect to this determination.

VI. *Proposed §1.199A-12, EAG Rules*

Proposed §1.199A-12 provides guidance on the application of section 199A(g) to an EAG under section 199A(g)(5)(A)(iii) that includes a Specified Cooperative. Unlike the section 199 deduction, the section 199A(g) deduction is limited to Specified Cooperatives. These proposed regulations address how the rules separating patronage and nonpatronage income and deductions apply in the context of an EAG. Proposed §1.199A-12 provides that in the case of nonexempt Specified Cooperatives, attribution between the members of an EAG is allowed provided the DPGR and related deductions are patronage. In the case of exempt Specified Cooperatives, attribution is allowed in all events because exempt Specified Cooperatives are allowed to take a separate 199A(g) deduction on both their patronage and nonpatronage income.

Proposed §1.199A-12 also provides certain rules for partnerships owned by an EAG as described in section 199A(g)(5)(A)(ii).

VII. *Proposed §1.1388-1(f)*

Proposed §1.1388-1(f) sets forth a definition of *patronage and nonpatronage* that is consistent with the current case law under section 1388. Specifically, the proposed definition adopts the directly related test, which is a fact specific test for determining whether income and deductions of a Cooperative are patronage or nonpatronage. The Treasury Department and the IRS request comments with respect to this definition.

VIII. *Proposed Removal of Section 199 Regulations and Withdrawal of 2015 Proposed Regulations*

In light of the TCJA, the Treasury Department and the IRS propose to remove the section 199 regulations (§§1.199-0 through 1.199-9) and withdraw the 2015 Proposed Regulations because the regulations interpret a provision of the Code that has been repealed for taxable years beginning after December 31, 2017.

The proposed removal of these regulations is unrelated to the substance of the rules in the regulations, and no negative inference regarding the stated rules should be made. Such regulations are proposed to be removed from the Code of Federal Regulations (CFR) solely because they have no future applicability. Removal of these regulations is not intended to alter any non-regulatory guidance that cites to or relies upon these regulations. These regulations as contained in 26 CFR part 1, revised April 1, 2019, remain applicable to determining eligibility for the section 199 deduction for any taxable year that began before January 1, 2018. The beginning date of the taxable year of a partnership, S corporation, or a non-grantor trust or estate, rather than the taxable year of a partner, shareholder, or beneficiary is used to determine items that are taken into account for purposes of calculating a section 199 deduction. This is consistent with the initial application of section 199 in 2005. Items arising from a passthrough entity that had a fiscal year beginning before 2005 were not taken into account by calendar-year partners for purposes of the section 199 deduction. Public Law 109-135, section 102(a) (Gulf Opportunity Zone Act of 2005). Further, when section 199 was amended to narrow the definition of W-2 wages, the amendment was effective for taxable years beginning after May 17, 2006. *See* Public Law 109-222, section 514(a) (Tax Increase Prevention and Reconciliation Act of 2005). Under the transition rule in §1.199-5(b)(4), partners and partnerships used the taxable year of the partnerships to determine the applicable definition of W-2 wages, and there are similar rules in §1.199-5(c)(4) for S corporations and §1.199-5(e)(3) for non-grantor trusts and estates.

Proposed Effective/Applicability Date

Section 7805(b)(1)(A) and (B) of the Code generally provide that no temporary, proposed, or final regulation relating to the internal revenue laws may apply to any taxable period ending before the earliest of (A) the date on which such regulation is filed with the *Federal Register*, or (B) in the case of a final regulation, the date on which a proposed or temporary regulation to which the final regulation relates was filed with the *Federal Register*.

Consistent with authority provided by section 7805(b)(1)(A), the proposed regulations are proposed to apply to taxable years beginning after the date of publication of a Treasury decision adopting these rules as final regulations in the *Federal Register*. Taxpayers may rely upon these proposed regulations, in their entirety, before the date of publication of the Treasury Decision adopting these rules as final regulations in the *Federal Register*.

Special Analyses

I. *Regulatory Planning and Review – Economic Analysis*

Executive Orders 13563 and 12866 direct agencies to assess costs and benefits of available regulatory alternatives and, if regulation is necessary, to select regulatory approaches that maximize net benefits (including potential economic, environmental, public health and safety effects, distributive impacts, and equity). Executive Order 13563 emphasizes the importance of quantifying both costs and benefits, of reducing costs, of harmonizing rules, and of promoting flexibility.

These proposed regulations have been designated by the Office of Management and Budget's Office of Information and Regulatory Affairs (OIRA) as subject to review under Executive Order 12866 pursuant to the Memorandum of Agreement (April 11, 2018) between the Treasury Department and the Office of Management and Budget regarding review of tax regulations. OIRA has determined that the proposed rulemaking is significant and subject to review under Executive Order 12866 and section 1(b) of the Memorandum of Agreement. Accordingly, the proposed regulations have been reviewed by the Office of Management and Budget.

In addition, the Treasury Department and the IRS expect the proposed regulations, when final, to be an Executive Order 13771 regulatory action and request comment on this designation.

A. *Background and Overview*

The TCJA repealed section 199, which provided a deduction for income attributable to domestic production activities. In its place it created section 199A, which provides a deduction for qualified business income derived from passthrough businesses – such as sole proprietorships, partnerships, and S corporations – engaged in domestic trades or businesses. While the repealed section 199 deduction was generally available to all taxpayers, the section 199A deduction is available only to taxpayers other than C corporations. On March 23, 2018, the 2018 Act modified section 199A(g) to provide deductions for Specified Cooperatives and their patrons that are substantially similar to those under the repealed section 199 deduction. Accordingly, these regulations generally formalize prior and current practices based on the rules under former section 199. The 2018 Act also added section 199A(b)(7), which requires patrons of Specified Cooperatives to reduce their section 199A(a) deduction if those patrons receive qualified payments from Specified Cooperatives.

The estimated number of Cooperatives affected by the 2018 Act and these proposed regulations is 9,000, including approximately 2,000 Specified Cooperatives, based on 2017 tax filings.

B. *Need for the Proposed Regulations*

The proposed regulations provide guidance regarding the application of sections 199A(a), 199A(b)(7), and 199A(g) to Cooperatives, Specified Cooperatives, and their patrons. The proposed regulations are needed because the 2018 Act introduced a number of terms and calculations. Patrons, Cooperatives, and Specified Cooperatives would benefit from greater specificity regarding these and other items.

C. *Economic Analysis*

1. Baseline

The Treasury Department and the IRS have assessed the benefits and costs of the proposed regulations relative to a no-action baseline reflecting anticipated Federal income tax-related behavior in the absence of these proposed regulations.

2. Economic Rationale for Issuing Guidance for the 2018 Act

The Treasury Department and the IRS anticipate that the issuance of guidance pertaining to sections 199A(a), 199A(b)(7), and 199A(g) of the 2018 Act to Cooperatives, Specified Cooperatives, and their patrons will provide a net economic benefit to the overall U.S. economy.

The proposed regulations clarify a number of concepts related to the section 199A(a) deduction for patrons of Cooperatives, provide guidance to patrons of Specified Cooperatives who may be required to reduce their section 199A(a) deduction under section 199A(b)(7), and provide guidance to Specified Cooperatives on the section 199A(g) deduction on income attributable to their domestic production activities. In the absence of guidance, affected taxpayers would have to calculate their tax liability without the definitions and clarifications provided by the proposed regulations, a situation that is generally considered more burdensome and could lead to greater conflicts with tax administrators. Thus, the Treasury Department and the IRS project that the proposed regulations will reduce taxpayer compliance burden and the costs of tax administration relative to not issuing any such guidance.

This guidance also ensures that section 199A deductions are calculated similarly across taxpayers, avoiding situations where one taxpayer receives preferential treatment over another for fundamentally similar economic activity. For example, in the absence of these proposed regulations, a Specified Cooperative may have uncertainty over what type of income is eligible for the section 199A(g) deduction. If a Specified Cooperative claimed the section 199A(g) deduction on income that already benefits from a lower corporate tax rate, this would confer an unintended economic benefit to the Specified Cooperative over other C corporations performing identical activities that only benefit from a lower corporate tax rate. As discussed further below, this guidance prevents the introduction of distortions of economic decisions in the agricultural or horticultural sector.

In the absence of these proposed regulations, uncertainty over statutory interpretation could lead to economic losses to the extent that taxpayers interpret the statute in ways that are inconsistent with the statute's intents and purposes. For example, a Specified Cooperative may pursue a project involving a certain product that is only profitable if that product is deemed "agricultural or horticultural" and thus eligible for the section 199A(g) deduction. If, in fact, this product is ineligible for the deduction based on the intents and purposes of the statute, then the project should not have been pursued and this results in an economic loss. Alternatively, without a definition of "agricultural or horticultural," a Specified Cooperative may incorrectly assume that a project is not eligible for the deduction and not pursue the project, which could also result in an economic loss. In such cases, guidance provides value by bringing economic decisions closer in line with Congress' intent or, when such intent is broad, with decisions that are economically efficient contingent on the overall Code. While no guidance can fully curtail all inaccurate interpretations of the statute, the proposed regulations significantly mitigate the chance for such interpretations and thereby increase economic efficiency. Due to the lack of readily available data, the Treasury Department and the IRS have not estimated the increase in United States economic activity that would arise from the proposed guidance.

The Treasury Department further projects that the issuance of guidance will reduce taxpayer compliance burden and the costs of tax administration relative to a no-action baseline. Due to the lack of readily available data, the Treasury Department has not estimated the decrease in taxpayer compliance burden nor tax administration costs arising from the issuance of guidance. The Treasury Department and the IRS request comments and information that can allow estimation of economic impacts and any changes in taxpayer compliance burden resulting from the proposed guidance.

3. Economic Analysis of Specific Provisions

The proposed regulations embody certain regulatory decisions that reflect necessary regulatory discretion. These decisions specify more fully how the 2018 Act is to be implemented.

The Treasury Department and the IRS solicit comments on the economic impacts of each of the items discussed in this section and of any other items of the proposed regulations not discussed in this section. The Treasury Department and the IRS particularly solicit comments that provide data, other evidence, or models that could enhance the rigor of the process by which provisions might be developed for the final regulations.

i. Determining Section 199A(g) Deduction

Specified Cooperatives are taxed differently depending on whether they are exempt (qualified as a cooperative under section 521) or nonexempt (qualified under rules elsewhere in the Code) and also whether their income is from patronage (generally related to the cooperative's marketing, purchasing, or services activities) or nonpatronage sources. In the case of exempt Specified Cooperatives patronage and nonpatronage source income is subject to a single level of tax at the patron level. Whereas, for nonexempt Specified Cooperatives only patronage source income is subject to a single level of tax at the patron level; nonpatronage source income is subject to a double level of tax, similar to other C corporations. Because the Code does not define *patronage and nonpatronage* source income, proposed §1.1388-1(f) sets forth a definition of *patronage and nonpatronage* that is consistent with the current state of federal case law. Specifically, the proposed definition adopts the directly related test, which is a fact specific test for determining whether income and deductions of a Cooperative are patronage or nonpatronage. Specifying a definition that is consistent with current case law will help to minimize the economic impacts of these proposed regulations. The Treasury Department and the IRS request comments with respect to this definition.

The TCJA reduced the corporate tax rate for C corporations under section 11 and provided the section 199A deduction for domestic businesses operated as sole proprietorships or through partnerships, S corporations, trusts, or estates. The TCJA also repealed section 199, which did not preclude deductions on income earned by C corporations. The 2018 Act amended section 199A to address concerns that the TCJA created an unintended incentive for farmers to sell their agricultural or horticultural products to Specified Cooperatives over independent buyers. Specifically, the 2018 Act amended section 199A(g) to allow Specified Cooperatives and their patrons a deduction similar to the former section 199 deduction. Because the section 199A(g) deduction is not intended to benefit C corporations and their shareholders in general, the proposed regulations specify that the section 199A(g) deduction can be claimed on income that can be subject to tax only at the patron level. Under the proposed regulations, non-exempt Specified Cooperatives may not claim the section 199A(g) deductions on income that cannot be paid to patrons and deducted under section 1382(b) and exempt Specified Cooperatives may not claim section 199A(g) deductions on income that cannot be paid to patrons and deducted under sections 1382(b) or 1382(c)(2).

In the absence of these proposed regulations, a Specified Cooperative may have uncertainty as to whether non-patronage source income, which would be taxed in the same manner as a C corporation, could receive both the lower corporate tax rate and be further offset by a section 199A(g) deduction. Other C corporations performing identical activities would only benefit from the lower corporate tax rate.

The Treasury Department and the IRS have determined that this potential uncertainty as to tax treatment could distort economic decisions in the agricultural or horticultural sector. The proposed regulations avoid this outcome, promoting a more efficient allocation of resources by providing more uniform incentives across taxpayers.

ii. Definition of *Agricultural or Horticultural Products*

Proposed §1.199A-8(a)(4) defines *agricultural or horticultural products* as agricultural, horticultural, viticultural, and dairy products, livestock and the products thereof, the products of poultry and bee raising, the edible products of forestry, and any and all products raised or produced on farms and processed or manufactured products thereof within the meaning of the Cooperative Marketing Act of 1926. Agricultural or horticultural products also include aquatic products that are farmed as well as fertilizer, diesel fuel, and other supplies used in agricultural or horticultural production that are MPGE by the Specified Cooperative. Agricultural or horticultural products, however, do not include intangible property, since agricultural or horticultural products were considered a subset of tangible property under former section 199. Intangible property (defined in §1.199-3(j)(2)(iii)) was a separate category of property and gross receipts from intangible property did not qualify as DPGR.

The Treasury Department and the IRS considered other definitions of agricultural or horticultural products but determined that taxpayer burden and tax administration costs would be lowest under a definition that was consistent with extant law.

For example, the Treasury Department and the IRS considered a similar but alternative definition of *agricultural or horticultural* products as agricultural, horticultural, viticultural, and dairy products, livestock and poultry, bees, forest products, fish and shellfish, and any products thereof, including processed and manufactured products, and any and all products raised or produced on farms and any processed or manufactured product thereof within the meaning of the Agricultural Marketing Act of 1946. While very similar to the definition in these proposed rules, the Treasury Department and the IRS proposed using the definition based on the Cooperative Marketing Act of 1926, which specifically concerns cooperatives and with which Specified Cooperatives are familiar, unlike the Agricultural Marketing Act of 1946, which concerns the marketing and distribution of agricultural products without reference to Cooperatives. The Treasury Department and the IRS looked to the United States Department of Agriculture (USDA) for definitions because there is no definition of *agricultural or horticultural products* in the Internal Revenue Code or Income Tax Regulations and because the USDA has expertise concerning Specified Cooperatives and because Specified Cooperatives are likely familiar with USDA law.

The Treasury Department and the IRS also considered an alternative definition of *agricultural or horticultural products* based on the definition of agricultural commodities within the meaning of general regulations under the Commodity Exchange Act. The Treasury Department and the IRS concluded that this definition was too narrow, because it is limited to products that can be commodities. The use of this narrow definition would have restricted the range of products for which the section 199A(g) deduction would be otherwise be available.

The Treasury Department and the IRS request comments on other approaches to defining agricultural or horticultural products. The Treasury Department and the IRS did not attempt to provide quantitative estimates of the revenue effects or economic consequences of different designations of agricultural or horticultural products because suitable data are not readily available at this level of detail. The Treasury Department and the IRS request comments that can inform such estimation.

iii. De Minimis Threshold

In general, proposed §1.199A-9 requires that Specified Cooperatives allocate gross receipts between domestic production gross receipts (DPGR) and non-DPGR. However, proposed §1.199A-9(c)(3) includes a de minimis provision that allows Specified Cooperatives to allocate total gross receipts to DPGR if less than 5 percent of total gross receipts are non-DPGR or to allocate total gross receipts to non-DPGR if less than 5 percent of total gross receipts are DPGR. The Treasury Department and the IRS chose to include a de minimis rule to reduce compliance costs and simplify tax filing relative to an alternative of no de minimis rule. The de minimis threshold modestly reduces compliance costs for businesses with relatively small amounts of non-DPGR or DPGR by allowing them to avoid allocating receipts between DPGR and non-DPGR activities. The de minimis threshold is unlikely to create any substantial effects on market activity because any change in the ratio of DPGR to non-DPGR will be localized around the threshold, meaning that the movement will be a small fraction of receipts to get below the de minimis threshold.

The thresholds provided in the proposed regulations are based on the thresholds set forth in §1.199-1(d)(3). The Treasury Department and the IRS maintained the de minimis rule from the final regulations under former section 199 because the 2018 Act directed that regulations concerning the section 199A(g) deduction be based on the regulations applicable to Cooperatives and their patrons under former section 199. The Treasury Department and the IRS considered changes in the de minimis provisions but determined that changing these from provisions that were previously available would lead to taxpayer confusion. Because the de minimis provision exempts taxpayers from having to perform certain allocations, the Treasury Department and the IRS do not have sufficient information on taxpayers' use of this exemption under former section 199 to perform a quantitative analysis of the impacts of the de minimis provision.

The Treasury Department and the IRS solicit comments on the de minimis thresholds and particularly request comments that provide data, other evidence, and models that can enhance the rigor of the process by which such thresholds might be determined for the final regulations while maintaining consistency with the statute's directive that the thresholds be based on regulations issued under former section 199.

iv. Reporting Requirements

Proposed §1.199A-7(c) and (d) provide that, when a patron conducts a trade or business that receives distributions from a Cooperative, the Cooperative is required to provide the patron with qualified items of income, gain, deduction, and loss and specified service trade or business (SSTB) determinations with respect to those distributions. This increases the compliance burden on such Cooperatives. However, in the absence of these proposed regulations, the burden for determination of the amount of distributions from a Cooperative that constitute qualified items of income, gain, deduction, and loss from a non-SSTB and an SSTB would lie with the patron. Because patrons are less well positioned to acquire the relevant information to determine whether distributions from a Cooperative are qualified items of income, gain, deduction, and loss and whether items that would otherwise qualify are from an SSTB, the Treasury Department and the IRS expect that these proposed regulations will reduce overall compliance costs relative to an alternative approach of not introducing a reporting requirement.

v. Allocation Safe Harbor

If a patron receives both qualified payments and payments that are not qualified payments in a qualified trade or business, the patron must allocate those items and related deductions using a reasonable method based on all of the facts and circumstances. The proposed regulations provide a safe harbor that allows patrons who receive qualified payments in addition to other income to use a simpler method to allocate business expenses and W-2 wages between qualified payments and other gross receipts to calculate the section 199A(b)(7) reduction to the section 199A(a) deduction. The safe harbor allocation method allows patrons to allocate by ratably apportioning business expenses and W-2 wages based on the proportion that the amount of qualified payments bears to the total gross receipts used to determine QBI. This safe harbor is available to patrons with taxable incomes below the threshold amounts set forth in section 199A(e)(2).

The Treasury Department and the IRS considered an alternative of not allowing a safe harbor but determined that a safe harbor could reduce compliance costs and simplify tax filing. The threshold was set at amounts set forth in section 199A(e)(2) to avoid a proliferation of thresholds applicable to taxpayers claiming a section 199A(a) deduction. Because the threshold amounts are relatively low, the Treasury Department and the IRS expect that the safe harbor would not distort business decisions or reduce revenue to any meaningful extent.

II. *Paperwork Reduction Act*

The collections of information in these proposed regulations are in proposed §1.199A-7(c)(3), (d)(3), (f)(3), and (h)(3), as well as proposed §1.199A-8(d)(3), (f), and (h)(3). The collections of information in proposed §1.199A-7(c)(3), (d)(3), (f)(3), and (h)(3), as well as proposed §1.199A-8(d)(3) and (h)(3) will be conducted through Form 1099-PATR, while the collection of information in proposed §1.199A-8(f) will be conducted through Schedule K-1 to Form 1065. In 2018, the IRS released and invited comments on the draft of Form 1065, Schedule K-1. The IRS received no comments on the form during the comment period. Consequently, the IRS made the form available December 6, 2018 for use by the public. On February 26, 2019, the IRS invited comments on Form 1099-PATR and the comment period closed on April 29, 2019. The IRS plans to issue in the near term an additional notice with a thirty-day comment period on Form 1099-PATR. The IRS is contemplating making additional changes to those two forms as discussed below in these proposed regulations .

A. *Collections of information conducted through Form 1099-PATR*

The collection of information in proposed §1.199A-7(c)(3) requires the Cooperative to inform its patron of the amount of any distribution to the patron that constitutes qualified items of income, gain, deduction, and loss from a non-SSTB conducted directly by the Cooperative. Not all distributions to patrons are qualified items of income, gain, deduction, and loss because the source of the distribution may not be effectively connected with the conduct of a trade or business within the United States or may include interest income that is not properly allocable to the patron's trade or business. The Cooperative directly conducting the trade or business from which the distribution to the patron originates is in the best position to know how much of the distribution is qualified items of income, gain, deduction, and loss. The Cooperative is also in the best position to know if it is generating income from an SSTB. Accordingly, the collection of information is necessary for the patron to calculate correctly the patron's section 199A(a) deduction for the patron's trade or business.

The collection of information in proposed §1.199A-7(d)(3) requires the Cooperative to inform its patron of the amount of any distributions to the patron that constitutes qualified items of income, gain, deduction, and loss from an SSTB conducted directly by the Cooperative. Accordingly, the collection of information is necessary for the patron to correctly calculate the patron's section 199A(a) deduction for the patron's qualified trade or business.

The collection of information in proposed §1.199A-7(f)(3) is essential for the eligible taxpayer's calculation of the reduction in the eligible taxpayer's section 199A(a) deduction for the eligible taxpayer's trade or business that is required by section 199A(b)(7). Section 199A(g)(2)(A) requires the Specified Cooperative to identify the amount of qualified payments being distributed to an eligible taxpayer and identify the portion of the deduction allowed in a notice mailed to the eligible taxpayer during the payment period described in section 1382(d). Section 199A(b)(7) provides that an eligible taxpayer who receives qualified payments from a Specified Cooperative must reduce the eligible taxpayer's section 199A(a) deduction by an amount set forth in this section. Without the notice described in proposed §1.199A-7(f)(3), the eligible taxpayer cannot calculate the reduction required by section 199A(b)(7).

The collection of information in proposed §1.199A-8(d)(3) is necessitated by section 199A(g)(2)(A). Section 199A(g)(2)(A) permits a Specified Cooperative to pass through an amount of its section 199A(g) deduction to an eligible taxpayer. The amount of the section 199A(g) deduction that the Specified Cooperative is permitted to pass through is an amount that is allocable to the QPAI generated from qualified payments distributed to the eligible taxpayer and identified by such cooperative in a written notice mailed to such taxpayer during the payment period described in section 1382(d). Without the notice required in proposed §1.199A-8(d)(3) the eligible taxpayer would not know that the Specified Cooperative is passing a portion of its section 199A(g) deduction to the eligible taxpayer.

The collections of information in proposed §§1.199A-7(h)(3) and 1.199A-8(h)(3) are necessitated by a special transition rule in section 101 of the 2018 Act. Under this transition rule, the repeal of former section 199 for taxable years beginning after December 31, 2017, does not apply to a qualified payment received by a patron from a Specified Cooperative in a taxable year beginning after December 31, 2017, to the extent such qualified payment is attributable to QPAI with respect to which a deduction is allowable to the Specified Cooperative under former section 199 for a taxable year of the Specified Cooperative beginning before January 1, 2018. Such qualified payment remains subject to former section 199 and no deduction is allowed under section 199A(a) or (g) with respect to such qualified payment. Without these collections of information by the Specified Cooperative, the patron has no way of knowing that the patron is barred by the transition rule from using a qualified payment received that is QBI for the patron's trade or business to claim a section 199A(a) deduction for the patron's trade or business.

The collections of information in proposed §1.199A-7(c)(3), (d)(3), (f)(3), and (h)(3) as well as proposed §1.199A-8(d)(3) and (h)(3) are satisfied by providing information about qualified items of income, SSTB determinations, qualified payments, the section 199A(g) deduction, and the use of qualified payments tied to the former section 199 deduction, as applicable, on an attachment to or on the Form 1099-PATR (or any successor form) issued by the Cooperative to the patron, unless otherwise provided by the instructions to the Form.

For purposes of the Paperwork Reduction Act of 1995, (44 U.S.C. 3507(d)) (PRA), the reporting burden associated with proposed §1.199A-7(c)(3), (d)(3), (f)(3), and (h)(3) as well as proposed §1.199A-8(d)(3) and (h)(3) will be reflected in the PRA Submission associated with Form 1099-PATR (OMB control number 1545-0118). As further discussed in this section, the estimated number of respondents for the reporting burden associated with these information collections is 9,000 based on 2017 tax filings.

B. *Collections of information conducted through Schedule K-1, Form 1065*

The collection of information in proposed §1.199A-8(f) is required by section 199A(g)(5)(B). This section allows a Specified Cooperative that is a partner in a partnership to use its allocable share of gross receipts and related deductions to calculate its section 199A(g) deduction. The proposed rules provide that the partnership must separately identify and report the allocable share of gross receipts and related deductions on or attached to the Schedule K-1 to the Form 1065 (or any successor form) issued to a Specified Cooperative partner, unless otherwise provided by the instructions to the Form. Without this reporting, the Specified Cooperative partner would not have the information necessary to calculate its section 199A(g) deduction from its activities with the partnership.

The Schedule K-1 to the Form 1065 will be modified to include a mechanism to report the Specified Cooperative partner's allocable share of gross receipts and related deductions. The collection of information in proposed §1.199A-8(f) is satisfied when the partnership provides the required information to its Specified Cooperative partners on or attached to the Schedule K-1 of Form 1065 (or any successor form), unless otherwise provided by the instructions to the Form. For purposes of the PRA, the reporting burden associated with proposed §1.199A-8(f) will be reflected in the PRA Submission associated with Form 1065 (OMB control number 1545-0123). As provided in this section, the estimated number of respondents for the reporting burden associated with these information collections is 407 based on 2017 tax filings.

C. *Revised tax forms*

The revised tax forms are as follows:

	New	Revision of existing form	Number of respondents
Form 1099-PATR		✓	**9,000**
Schedule K-1 (Form 1065)		✓	**407**

The current status of the PRA submissions related to the tax forms that will be revised as a result of the information collections in the proposed regulations is provided in the accompanying table. As described previously, the burdens associated with proposed §1.199A-7(c)(3), (d)(3), (f)(3), and (h)(3) as well as proposed §§1.199A-8(d)(3) and (h)(3) will be included in the aggregated burden estimates for OMB control number 1545-0118, which represents a total estimated burden time of 509,895 hours and total estimated monetized costs of $44.733 million ($2018). The burdens associated with the information collection in proposed §1.199A-8(f) will be included in the aggregated burden estimates for OMB control number 1545-0123, which represents a total estimated burden time for all forms and schedules of 3.157 billion hours and total estimated monetized costs of $58.148 billion ($2017). The overall burden estimates provided for 1545-0118 and 1545-0123 are aggregate amounts that relate to all information collections associated with the applicable OMB control number.

No burden estimates specific to the forms affected by the proposed regulations are currently available. The Treasury Department and the IRS have not estimated the burden, including that of any new information collections, related to the requirements under the proposed regulations. Those estimates would need to capture both changes made by the 2018 Act and those that arise out of discretionary authority exercised in the proposed regulations. The Treasury Department and the IRS request comments on all aspects of information collection burdens related to the proposed regulations, including estimates for how much time it would take to comply with the paperwork burdens described above for each relevant form and ways for the IRS to minimize the paperwork burden. Proposed revisions to these forms that reflect the information collections contained in these proposed regulations will be made available for public comment at https://apps.irs.gov/app/picklist/list/draftTaxForms.htm and will not be finalized until after these forms have been approved by OMB under the PRA.

Form	Type of Filer	OMB Number(s)	Status
Form 1099-PATR	[Business (Legacy Model)]	1545-0118	Existing collection of information approved by OIRA on 6/3/2016. Public comments will be sought on a revised collection of information that will be submitted for OIRA review before 6/30/2019.
	Link: https://www.reginfo.gov/public/do/PRAViewICR?ref_nbr=201602-1545-024		
Form 1065, Schedule K-1	Business (NEW Model)	1545-0123	Published in the *Federal Register* on 10/11/18. Public Comment period closed on 12/10/18. Approved by OIRA on 12/21/18.
	Link: https://www.federalregister.gov/documents/2018/10/09/2018-21846/proposed-collection-comment-request-for-forms-1065-1065-b-1066-1120-1120-c-1120-f-1120-h-1120-nd		

III. *Regulatory Flexibility Act*

As described in more detail in this section, pursuant to the Regulatory Flexibility Act (RFA), 5 U.S.C. chapter 6, the Treasury Department and the IRS hereby certify that these proposed regulations will not have a significant economic impact on a substantial number of small entities. Notwithstanding this certification, the Treasury Department and the IRS invite comments on any impact this rule would have on small entities.

A. *Proposed §1.199A-7(c)(3) and (d)(3)*

Although proposed §1.199A-7(c)(3) and (d)(3) will have an impact on a substantial number of small entities, the economic impact will not be significant. The IRS creates the Business Master File which contains data from Form 1120-C, U.S. Income Tax Return for Cooperative Associations. According to the Business Master File data, in 2017, the IRS received approximately 9,000 Forms 1120-C from Cooperatives. Under the North American Industry Classification System (NAICS), a Cooperative is considered a small entity if it has less than $750,000 in annual gross receipts. Approximately 4,050 (45 percent) of the 9,000 filers of Forms 1120-C reported annual gross receipts of less than $750,000. Therefore, a substantial number of small entities are affected by the requirements in proposed §1.199A-7(c)(3) and (d)(3).

Proposed §1.199A-7 provides rules similar to those provided in §1.199A-6. In §1.199A-6, relevant passthrough entities (RPEs) are not permitted to take the section 199A deduction but are required to determine and report the information necessary for their direct and indirect owners to determine their individual section 199A(a) deductions. Section 1.199A-6 requires RPEs to determine and report on or attach to the RPEs' Schedule K-1s to the Form 1065 for each trade or business in which the RPE was directly engaged four items: (1) The amount of QBI, (2) W-2 wages, (3) UBIA of qualified property, and (4) SSTBs.

Although Cooperatives are not RPEs, Cooperatives make distributions to patrons that such patrons are permitted to include in calculating their individual section 199A(a) deductions. Proposed §1.199A-7(c) and (d) require the Cooperatives to determine and report to their patrons whether the distributions for which the Cooperatives take deductions under section 1382(b) and/or (c)(2), as applicable, constitute qualified items of income, gain, deduction, and loss and whether they are from an SSTB in which the Cooperative was directly engaged.

In TD 9847 the Treasury Department and the IRS determined that the reporting burden in §1.199A-6 was estimated at 30 minutes to 20 hours, depending on individual circumstances, with an estimated average of 2.5 hours for all affected entities, regardless of size. The burden on entities with business receipts below $10 million was expected to be at the lower end of the range (30 minutes to 2.5 hours). The estimated compliance burden for passthrough entities that issue Schedules K-1 is $53 per hour. This estimate was derived from the Business Taxpayer Burden model developed by the IRS's Office of Research, Applied Analytics, and Statistics (RAAS), which relates time and out-of-pocket costs of business tax preparation, derived from survey data, to assets and receipts of affected taxpayers along with other relevant variables. *See* Tax Compliance Burden (John Guyton et al., July 2018) at https://www.irs.gov/pub/irs-soi/d13315.pdf. Thus, the annual aggregate burden on businesses with gross receipts below $10 million was estimated to be between $19.50 and $132.50 per business. The Treasury Department and the IRS determined in TD 9847 that the requirements in §1.199A-6 imposed no significant economic impact on affected entities.

The reporting requirements under proposed §1.199A-7(c)(3) and (d)(3) require Specified Cooperatives to report only two of the four pieces of information RPEs are required to report under proposed §1.199A-6: the amount of qualified items of income, gain, deduction, and loss and whether the distributions are from an SSTB in which the Cooperative was directly engaged.

The burden imposed by proposed §1.199A-7(c)(3) and (d)(3) only occurs when a Cooperative has net income that it may distribute to its patrons such that the income will qualify for the income tax deductions under section 1382(b) and/or (c), as applicable. With respect to this net income, Cooperatives already know the source of their income and deductions without which information they would not be able to determine the correct distributions to their patrons and to claim the income tax deduction for these distributions under section 1382(b) and/or (c)(2), as applicable. Finally, assuming that the approximately 4,050 filers of Forms 1120-C that reported annual gross receipts of less than $750,000 in 2017 and that each business incurred half of the higher figure of $132.50 ($66.25) determined for the §1.199A-6 regulations to satisfy the reporting requirements under proposed §1.199A-7(c)(3) and (d)(3), the annual burden imposed by the reporting requirements would not exceed $66.25 per business. Accordingly, the Treasury Department and the IRS conclude that the requirements in proposed §1.199A-7(c)(3) and (d)(3) will not impose a significant economic impact on small entities.

B. *Proposed §§1.199A-7(h)(3) and 1.199A-8(h)(3)*

Although proposed §§1.199A-7(h)(3) and 1.199A-8(h)(3) will have an impact on a substantial number of small entities, this economic impact will not be significant. As previously noted, in 2017, approximately 45 percent of Cooperatives reported on Forms 1120-C gross receipts of less than $750,000. Therefore, a substantial number of small entities are affected by proposed §§1.199A-7(h)(3) and 1.199A-8(h)(3).

Proposed §§1.199A-7(h)(3) and 1.199A-8(h)(3) requires Cooperatives to notify patrons if, pursuant to the transition rule in section 101 of the 2018 Act, the patron is barred from using certain qualified payments from a Cooperative to claim a section 199A(a) deduction in a taxable year because these qualified payments are attributable to QPAI with respect to which a deduction is allowable to the Cooperative under former section 199 in a taxable year beginning before January 1, 2018. The Cooperative knows which patrons are impacted since, in order to claim its deduction under former section 199, the Cooperative must identify which qualified payments to use. The Treasury Department and the IRS estimate that the annual burden imposed by the requirement in proposed §§1.199A-7(h)(3) and 1.199A-8(h)(3) will be far less than the $66.25 per business estimated for the requirements in proposed §§1.199A-7(c)(3) and 1.199A-8(c)(3) discussed above, since the Cooperatives know which patrons are impacted and the reporting is limited to informing these patrons that they cannot use such qualified payments to calculate their section 199A(a) deduction.

In addition, absent notice from the Cooperatives, patrons would have no way of determining whether they were barred from claiming the section 199A(a) deduction using such qualified payments. Finally, Cooperatives are not able to claim a deduction under former section 199 for taxable years beginning after December 31, 2017. Therefore, the reporting required by proposed §§1.199A-7(h)(3) and 1.199A-8(h)(3) will be for a short duration and have a limited impact on Cooperatives. Accordingly, for all these reasons, the requirements in proposed §§1.199A-7(h)(3) and 1.199A-8(h)(3) will not impose a significant economic impact on small entities.

C. *Proposed §§1.199A-7(f)(3) and 1.199A-8(d)(3)*

Sections 1.199A-7(f)(3) and 1.199A-8(d)(3) will not have a significant economic impact on a substantial number of small entities. This claim is based on the fact that this rulemaking will impact a population of Specified Cooperatives, only a small percentage of which are considered small entities. According to the Business Master File filing data from the transcribed fields from the Forms 1120-C for 2017, of the approximately 9,000 Forms 1120-C filed by Cooperatives, approximately 2,000 filers identified their Cooperatives as involving agriculture or horticulture using the NAICS. As noted previously, a Cooperative is considered small if it reports less than $750,000 in annual gross receipts. Of the 2,000 filers of Forms 1120-C identifying as Specified Cooperatives, only 175 filers (less than 1 percent) reported annual gross receipts of less than $750,000. Accordingly, proposed §§1.199A-7(f)(3) and 1.199A-8(d)(3) will not impose a significant economic impact on a substantial number of small entities.

D. *Proposed §1.199A-8(f)*

Although proposed §1.199A-8(f) will have an impact on a substantial number of small entities, this impact will not be economically significant. According to the Business Master File filing data from the transcribed fields from the Forms 1065 for 2017, the IRS estimates that there were 3,954,000 partnerships reporting their partners' share of partnership items on Schedules K-1 (Form 1065). The IRS also identified approximately 407 different partnerships that issued a Schedule K-1 to 680 different Cooperatives in 2017. The IRS does not have information as to whether the 680 Cooperatives all qualified as Specified Cooperatives.

Of the 407 different partnerships, the IRS determined that 344 of the partnerships conducted activities in 2017 that would have required the partnerships to file under proposed §1.199A-8(f). The IRS does not have sufficient data to determine the type of business activities of the remaining 63 partnerships. To be as comprehensive and transparent as possible in analyzing the potential impact of the proposed regulations, it is assumed that all 63 of these partnerships would be required to file under proposed §1.199A-8(f) and would be considered small entities.

Of the 344 partnerships identified as having both issued a Schedule K-1 to a Cooperative and conducting eligible activities in 2017, the IRS determined that 158 of these partnerships conducted activities for which the Small Business Administration (SBA) uses the number of employees to determine if an entity is a small entity using the NAICS. The IRS determined that 153 of these 158 partnerships would be small entities, while five would not be small entities based on the reported number of Forms W-2 filed in connection with the Forms 1065 the partnerships filed in 2017.

The SBA uses income to determine if an entity is a small entity for the reported business activities of the remaining 186 partnerships using the NAICS. Based upon the reported income for 2017, 140 of the remaining 186 partnerships are small entities, while 46 partnerships are not small entities. Therefore, a substantial number of small entities are affected by requirements in proposed §1.199A-8(f).

The economic impact of proposed §1.199A-8(f), however, will not be significant because the information required to be reported is gross receipts and related deductions. This information is readily available to each partnership and already known for the purpose of determining tax obligations. Because the information required to be reported is already available and familiar to each partnership, the reporting required by proposed §1.199A-8(f) will not impose a significant economic impact on small entities.

Accordingly, the Treasury Department and the IRS hereby certify that the proposed regulations will not have a significant economic impact on a substantial number of small entities. We invite public comments with respect to this conclusion.

Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking has been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

IV. *Unfunded Mandates Reform Act*

Section 202 of the Unfunded Mandates Reform Act of 1995 (UMRA) requires that agencies assess anticipated costs and benefits and take certain other actions before issuing a final rule that includes any Federal mandate that may result in expenditures in any one year by a state, local, or tribal government, in the aggregate, or by the private sector, of $100 million in 1995 dollars, updated annually for inflation. In 2018, that threshold is approximately $150 million. This rule does not include any Federal mandate that may result in expenditures by state, local, or tribal governments, or by the private sector in excess of that threshold.

V. *Executive Order 13132: Federalism*

Executive Order 13132 (titled *Federalism*) prohibits an agency from publishing any rule that has federalism implications if the rule either imposes substantial, direct compliance costs on state and local governments, and is not required by statute, or preempts state law, unless the agency meets the consultation and funding requirements of section 6 of the Executive Order. This proposed rule does not have federalism implications, and does not impose substantial direct compliance costs on state and local governments or preempt state law, within the meaning of the Executive Order.

Comments and Requests for a Public Hearing

The Treasury Department and the IRS request comments on all aspects of the proposed rules. Before these proposed regulations are adopted as final regulations, consideration will be given to any written or electronic comments that are submitted timely to the IRS. All comments will be available for public inspection and copying. A public hearing may be scheduled if requested in writing by any person who timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place for the hearing will be published in the *Federal Register*.

Statement of Availability of IRS Documents

IRS Revenue Procedures, Revenue Rulings, Notices and other guidance cited in this document are published in the Internal Revenue Bulletin and are available from the Superintendent of Documents, U.S. Government Publishing Office, Washington, DC 20402, or by visiting the IRS website at http://www.irs.gov.

Drafting Information

The principal author of these proposed regulations is Theresa Melchiorre, Office of Associate Chief Counsel (Passthroughs and Special Industries). Other personnel from the Treasury Department and the IRS participated in their development.

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Withdrawal of Notice of Proposed Rulemaking

Accordingly, under the authority of 26 U.S.C. 7805, the notice of proposed rulemaking (REG-136459-09) published in the *Federal Register* (80 FR 51978) on August 27, 2015, is withdrawn.

Proposed Amendments to the Regulations

Accordingly, 26 CFR parts 1 is proposed to be amended as follows:

PART 1 – INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by:

1. Removing the entries for §§ 1.199-0 through 1.199-9, and
2. Adding entries in numerical order to read in part as follows:

Authority: 26 U.S.C. 7805

* * * * *

Section 1.199A-7 also issued under 26 U.S.C. 199A(f)(4) and (g)(6).

Section 1.199A-8 also issued under 26 U.S.C. 199A(g)(6).

Section 1.199A-9 also issued under 26 U.S.C. 199A(g)(6).

Section 1.199A-10 also issued under 26 U.S.C. 199A(g)(6).

Section 1.199A-11 also issued under 26 U.S.C. 199A(g)(6).

Section 1.199A-12 also issued under 26 U.S.C. 199A(g)(6).

* * * * *

§§1.199-0 through 1.199-9 [Removed]

Par. 2. Sections 1.199-0 through 1.199-9 are removed.

Par. 3. Sections 1.199A-7 through 1.199A-12 are added to read as follows:

Sec.

* * * * *

1.199A-7 Section 199A(a) Rules for Cooperatives and their Patrons.

1.199A-8 Deduction for income attributable to domestic production activities of specified agricultural or horticultural cooperatives.

1.199A-9 Domestic production gross receipts.

1.199A-10 Allocation of costs of goods sold (COGS) and other deductions to domestic production gross receipts (DPGR), and other rules.

1.199A-11 Wage limitation for the section 199A(g) deduction.

1.199A-12 Expanded affiliated groups.

* * * * *

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

(a) *Overview*—(1) *In general*. This section provides guidance and special rules on the application of the rules of §§1.199A-1 through 1.199A-6 regarding the deduction for qualified business income (QBI) under section 199A(a) (section 199A(a) deduction) of the Internal Revenue Code (Code) by patrons (patrons) of cooperatives to which Part I of subchapter T of chapter 1 of subtitle A of the Code applies (Cooperatives). Unless otherwise provided in this section, all of the rules in §§1.199A-1 through 1.199A-6 relating to calculating the section 199A(a) deduction apply to patrons and Cooperatives. Paragraph (b) of this section provides special rules for patrons relating to trades or businesses. Paragraph (c) of this section provides special rules for patrons and Cooperatives relating to the definition of QBI. Paragraph (d) of this section provides special rules for patrons and Cooperatives relating to specified service trades or businesses (SSTBs). Paragraph (e) of this section provides special rules for patrons relating to the statutory limitations based on W-2 wages and unadjusted basis immediately after acquisition (UBIA) of qualified property. Paragraph (f) of this section provides special rules for specified agricultural or horticultural cooperatives (Specified Cooperatives) and paragraph (g) of this section provides examples for Specified Cooperatives and their patrons. Paragraph (h) of this section sets forth the applicability date of this section and a special transition rule relating to Specified Cooperatives and their patrons.

(2) *At patron level*. The section 199A(a) deduction is applied at the patron level, and patrons who are individuals (as defined in §1.199A-1(a)(2)) may take the section 199A(a) deduction.

(3) *Definitions*. For purposes of section 199A and §1.199A-7, the following definitions apply—

(i) *Individual* is defined in §1.199A-1(a)(2).

(ii) *Patron* is defined in §1.1388-1(e).

(iii) *Patronage and nonpatronage* is defined in §1.1388-1(f).

(iv) *Relevant Passthrough Entity (RPE)* is defined in §1.199A-1(a)(9).

(v) *Qualified payment* is defined in §1.199A-8(d)(2)(ii).

(vi) *Specified Cooperative* is defined in §1.199A-8(a)(2) and is a subset of Cooperatives defined in §1.199A-7(a)(1).

(b) *Trade or business*. A patron (whether the patron is an RPE or an individual) must determine whether it has one or more trades or businesses that it directly conducts as defined in §1.199A-1(b)(14). To the extent a patron operating a trade or business has income directly from that business, the patron must follow the rules of §§1.199A-1 through 1.199A-6 to calculate the section 199A deduction. Patronage dividends or similar payments are considered to be generated from the trade or business the Cooperative conducts on behalf of or with the patron, and are tested by the Cooperative at its trade or business level. A patron that receives patronage dividends or similar payments, as described in paragraph (c)(1) of this section, from a Cooperative must follow the rules of paragraphs (c) through (e) of this section to calculate the section 199A deduction.

(c) *Qualified Business Income*—(1) *In general*. QBI means the net amount of qualified items of income, gain, deduction, and loss with respect to any trade or business as determined under the rules of §1.199A-3(b). A qualified item of income includes distributions for which the Cooperative is allowed a deduction under section 1382(b) and (c)(2) (including patronage dividends or similar payments, such as money, property, qualified written notices of allocations, and qualified per-unit retain certificates, as well as money or property paid in redemption of a nonqualified written notice of allocation (collectively patronage dividends or similar payments)), provided such distribution is otherwise a qualified item of income, gain, deduction, or loss. *See* special rule in paragraph (d)(3) of this section relating to SSTBs that may affect QBI.

(2) *QBI determinations made by patron*. A patron must determine QBI for each trade or business it directly conducts. In situations where the patron receives distributions described in paragraph (c)(1) of this section, the Cooperative must determine whether those distributions include qualified items of income, gain, deduction, and loss. These distributions may be included in the QBI of the patron's trade or business:

(i) To the extent that those payments are related to the patron's trade or business;

(ii) Are qualified items of income, gain, deduction, and loss at the Cooperative's trade or business level;

(iii) Are not income from an SSTB at the Cooperative's trade or business level (except as permitted by the threshold rules (*see* §1.199A-5(a)(2)); and

(iv) Provided the patron receives certain information from the Cooperative about these payments as provided in paragraphs (c)(3) and (d)(3) of this section.

(3) *Qualified items of income, gain, deduction, and loss determinations made and reported by Cooperatives*. In the case of a Cooperative that makes distributions described in paragraph (c)(1) of this section to a patron, the Cooperative must determine the amount of qualified items of income, gain, deduction, and loss in those distributions. Pursuant to this paragraph (c)(3), the Cooperative must report the amounts of qualified items with respect to any non-SSTB of the Cooperative in the distributions made to the patron on an attachment to or on the Form 1099-PATR, Taxable Distributions Received From Cooperatives (Form 1099-PATR), (or any successor form) issued by the Cooperative to the patron, unless otherwise provided by the instructions to the Form. If the Cooperative does not report on or before the due date of the Form 1099-PATR the amount of such qualified items of income, gain, deduction, and loss in the distributions to the patron, the amount of distributions from the Cooperative that may be included in the patron's QBI is presumed to be zero. *See* special rule in paragraph (d)(3) of this section relating to reporting of qualified items of income, gain, deduction, and loss with respect to SSTBs of the Cooperative.

(d) *Specified Service Trades or Businesses*—(1) *In general*. This section provides guidance on the determination of SSTBs. Unless otherwise provided in this section, all of the rules in §1.199A-5 relating to SSTBs apply to patrons of Cooperatives.

(2) *SSTB determinations made by patron*. A patron (whether an RPE or an individual) must determine whether each trade or business it directly conducts is an SSTB.

(3) *SSTB determinations made and reported by Cooperatives*. In the case of a Cooperative that makes distributions described in paragraph (c)(1) of this section to a patron, the Cooperative must determine whether the distributions from the Cooperative include items of income, gain, deduction, and loss from an SSTB directly conducted by the Cooperative, and whether such items are qualified items of income, gain, deduction, and loss with respect to such SSTB. The Cooperative must report to the patron the amount of income, gain, deduction, and loss in the distributions that is a qualified item of income, gain, deduction, and loss with respect to such SSTB. The Cooperative must report the amount on an attachment to or on the Form 1099-PATR (or any successor form) issued by the Cooperative to the patron, unless otherwise provided by the instructions to the Form. If the Cooperative does not report the amount on or before the due date of the Form 1099-PATR, then only the amount that a Cooperative reports as qualified items of income, gain, deduction, and loss under §1.199A-7(c)(3) may be included in the patron's QBI, and the remaining amount of distributions from the Cooperative that may be included in the patron's QBI is presumed to be zero.

(e) *W-2 wages and unadjusted basis immediately after acquisition of qualified property*—(1) *In general*. This section provides guidance on calculating a trade or business's W-2 wages and the UBIA of qualified property properly allocable to QBI.

(2) *Determinations made by patron*. The determination of W-2 wages and UBIA of qualified property must be made for each trade or business by the patron (whether an RPE or individual) that directly conducts the trade or business before applying the aggregation rules of §1.199A-4. Unlike RPEs, Cooperatives do not allocate their W-2 wages and UBIA of qualified property to patrons.

(f) *Special rules for patrons of Specified Cooperatives*—(1) *Section 199A(b)(7) reduction*. A patron of a Specified Cooperative that receives a qualified payment must reduce its section 199A(a) deduction as provided in §1.199A-1(e)(7). This reduction applies whether the Specified Cooperative passes through all, some, or none of the Specified Cooperative's section 199A(g) deduction to the patron in that taxable year. The proposed rules relating to the section 199A(g) deduction can be found in §§1.199A-8 through 1.199A-12.

(2) *Deduction Calculation*—(i) *Allocation method*. If in any taxable year, a patron receives both qualified payments and income that is not a qualified payment in a trade or business, the patron must allocate those items and related deductions using a reasonable method based on all the facts and circumstances. Different reasonable methods may be used for different items and related deductions of income, gain, deduction, and loss. The chosen reasonable method for each item must be consistently applied from one taxable year of the patron to another, and must clearly reflect the income and expenses of each trade or business. The overall combination of methods must also be reasonable based on all the facts and circumstances. The books and records maintained for a trade or business must be consistent with any allocations under this paragraph (f)(2)(i).

(ii) *Safe harbor*. A patron with taxable income under the threshold amount set forth in section 199A(e)(2) is eligible to use the safe harbor set forth in this paragraph (f)(2)(ii) instead of the allocation method set forth in paragraph (f)(2)(i) of this section for any taxable year in which the patron receives qualified payments and income from other than qualified payments in its trade or business. Under the safe harbor the patron may apportion its deductions and W-2 wages ratably between income from qualified payments and income from other than qualified payments for purposes of calculating the reduction in paragraph (f)(1) of this section. Accordingly, the amount of deductions apportioned to determine QBI allocable to qualified payments is equal to the proportion of the total deductions that the amount of qualified payments bears to total gross receipts used to determine QBI. The same proportion applies to determine the amount of W-2 wages allocable to the portion of the trade or business that received qualified payments.

(3) *Qualified payments notice requirement*. A Specified Cooperative must report the amount of the qualified payments made to the eligible taxpayer, as defined in section 199A(g)(2)(D), on an attachment to or on the Form 1099-PATR (or any successor form) issued by the Cooperative to the patron, unless otherwise provided by the instructions to the Form.

(g) *Examples*. The following examples illustrate the provisions of paragraph (f) of this section. For purposes of these examples, assume that the Specified Cooperative has satisfied the applicable written notice requirements in paragraphs (c)(3), (d)(3) and (f)(3) of this section.

(1) *Example 1. Patron of Specified Cooperative with W-2 wages*. (i) P, a grain farmer and patron of nonexempt Specified Cooperative (C), delivered to C during 2018 2% of all grain marketed through C during such year. During 2019, P receives $20,000 in patronage dividends and $1,000 of allocated section 199A(g) deduction from C related to the grain delivered to C during 2018.

(ii) P has taxable income of $75,000 for 2019 (determined without regard to section 199A) and has a filing status of married filing jointly. P's QBI related to its grain trade or business for 2019 is $50,000, which consists of gross receipts of $150,000 from sales to an independent grain elevator, per-unit retain allocations received from C during 2019 of $80,000, patronage dividends received from C during 2019 related to C's 2018 net earnings of $20,000, and expenses of $200,000 (including $50,000 of W-2 wages).

(iii) The portion of QBI from P's grain trade or business related to qualified payments received from C during 2019 is $10,000, which consists of per-unit retain allocations received from C during 2019 of $80,000, patronage dividends received from C during 2019 related to C's 2018 net earnings of $20,000, and properly allocable expenses of $90,000 (including $25,000 of W-2 wages).

(iv) P's deductible amount related to the grain trade or business is 20% of QBI ($10,000) reduced by the lesser of 9% of QBI related to qualified payments received from C ($900) or 50% of W-2 wages related to qualified payments received from C ($12,500), or $9,100. As P does not have any other trades or businesses, the combined QBI amount is also $9,100.

(v) P's deduction under section 199A for 2019 is $10,100, which consists of the combined QBI amount of $9,100, plus P's deduction passed through from C of $1,000.

(2) *Example 2. Patron of Specified Cooperative without W-2 wages*. (i) C and P have the same facts for 2018 and 2019 as *Example 1*, except that P has expenses of $200,000 that include zero W-2 wages during 2019.

(ii) P's deductible amount related to the grain trade or business is 20% of QBI ($10,000) reduced by the lesser of 9% of QBI related to qualified payments received from C ($900) or 50% of W-2 wages related to qualified payments received from C ($0), or $10,000.

(iii) P's deduction under section 199A for 2019 is $11,000, which consists of the combined QBI amount of $10,000, plus P's deduction passed through from C of $1,000.

(3) *Example 3. Patron of Specified Cooperative – Qualified Payments do not equal QBI and no section 199A(g) passthrough*. (i) P, a grain farmer and a patron of a nonexempt Specified Cooperative (C), during 2019, receives $60,000 in patronage dividends, $100,000 in per-unit retain allocations, and $0 of allocated section 199A(g) deduction from C related to the grain delivered to C. C notifies P that only $150,000 of the patronage dividends and per-unit retain allocations are qualified payments because $10,000 of the payments are not attributable to C's qualified production activities income (QPAI).

(ii) P has taxable income of $90,000 (determined without regard to section 199A) and has a filing status of married filing jointly. P's QBI related to its grain trade or business is $45,000, which consists of gross receipts of $95,000 from sales to an independent grain elevator, plus $160,000 from C (all payments from C qualify as qualified items of income, gain, deduction, and loss), less expenses of $210,000 (including $30,000 of W-2 wages).

(iii) The portion of QBI from P's grain trade or business related to qualified payments received from C is $25,000, which consists of the qualified payments received from C of $150,000, less the properly allocable expenses of $125,000 (including $18,000 of W-2 wages), which were determined using a reasonable method under paragraph (f)(2)(ii) of this section.

(iv) P's patron reduction is $2,250, which is the lesser of 9% of QBI related to qualified payments received from C, $2,250 (9% x $25,000), or 50% of W-2 wages related to qualified payments received from C, $9,000 (50% x $18,000). As P does not have any other trades or businesses, the combined QBI amount is $6,750 (20% of P's total QBI, $9,000 (20% x $45,000), reduced by the patron reduction of $2,250).

(v) P's deduction under section 199A is $6,750, which consists of the combined QBI amount of $6,750.

(4) *Example 4. Patron of Specified Cooperative – Reasonable Method under paragraph (f)(2)(ii) of this section*. P is a grain farmer that has $45,000 of QBI related to P's grain trade or business in 2019. P's QBI consists of $105,000 of sales to an independent grain elevator, $100,000 of per-unit retain allocations, and $50,000 of patronage dividends from a nonexempt Specified Cooperative (C), for which C reports $150,000 of qualified payments to P as required by paragraph (f)(3) of this section. P's grain trade or business has $210,000 of expenses (including $30,000 of W-2 wages). P delivered 65x bushels of grain to C and sold 35x bushels of comparable grain to the independent grain elevator. To allocate the expenses between qualified payments ($150,000) and other income ($105,000), P compares the bushels of grain delivered to C (65x) to the total bushels of grain delivered to C and sold to the independent grain elevator (100x). P determines $136,500 (65% x $210,000) of expenses (including $19,500 of W-2 wages) are properly allocable to the qualified payments. The portion of QBI from P's grain trade or business related to qualified payments received from C is $13,500, which consists of qualified payments of $150,000 less the properly allocable expenses of $136,500 (including $19,500 of W-2 wages). P's method of allocating expenses is a reasonable method under paragraph (f)(2)(ii) of this section.

(5) *Example 5. Patron of Specified Cooperative using safe harbor to allocate*. (i) P is a grain farmer with taxable income of $100,000 for 2019 (determined without regard to section 199A) and has a filing status of married filing jointly. P's QBI related to P's grain trade or business for 2019 is $50,000, which consists of gross receipts of $180,000 from sales to an independent grain elevator, per-unit retain allocations received from a Specified Cooperative (C) during 2019 of $15,000, patronage dividends received from C during 2019 related to C's 2018 net earnings of $5,000, and expenses of $150,000 (including $50,000 of W-2 wages). C also passed through $1,800 of the section 199A(g) deduction to P, which related to the grain delivered by P to the Specified Cooperative during 2018. P uses the safe harbor in paragraph (f)(2)(iii) of this section to determine the expenses (including W-2 wages) allocable to the qualified payments.

(ii) Using the safe harbor to allocate P's $150,000 of expenses, P allocates $15,000 of the expenses to the qualified payments ($150,000 of expenses multiplied by the ratio (0.10) of qualified payments ($20,000) to total gross receipts ($200,000)). Using the same ratio, P also determines there are $5,000 of W-2 wages allocable ($50,000 multiplied by 0.10) to the qualified payments.

(iii) The portion of QBI from P's grain trade or business related to qualified payments received from C during 2019 is $5,000, which consists of per-unit retain allocations received from C during 2019 of $15,000, patronage dividends of $5,000, and properly allocable expenses of $15,000 (including $5,000 of W-2 wages).

(iv) P's QBI related to the grain trade or business is 20% of QBI ($10,000) reduced by the lesser of 9% of QBI related to qualified payments received from C ($450) or 50% of W-2 wages related to qualified payments received from C ($2,500), or $9,550. As P does not have any other trades or businesses, the combined QBI amount is also $9,550.

(v) P's deduction under section 199A for 2019 is $11,350, which consists of the combined QBI amount of $9,550, plus P's deduction passed through from C of $1,800.

(h) *Effective/applicability date*—(1) *General rule*. Except as provided in paragraph (h)(2) of this section, the provisions of this section apply to taxable years ending after the date the Treasury decision adopting these regulations as final regulations is published in the *Federal Register*. Taxpayers, however, may rely on these regulations until that date, but only if the taxpayers apply the rules in their entirety and in a consistent manner.

(2) *Transition rule for qualified payments of patrons of Cooperatives*. No deductions under section 199A are allowed to patrons for any qualified payments that are attributable to QPAI with respect to which a deduction is allowable to the Specified Cooperative under section 199 as in effect on and before December 31, 2017, for a taxable year of the Specified Cooperative beginning before January 1, 2018.

(3) *Notice from the Cooperative*. If a patron of a Cooperative cannot claim a deduction under section 199A for any qualified payments described in the transition rule set forth in paragraph (h)(2) of this section, the Cooperative must report this information on an attachment to or on the Form 1099-PATR (or any successor form)

issued by the Cooperative to the patron, unless otherwise provided by the instructions to the Form.

§1.199A-8 Deduction for income attributable to domestic production activities of specified agricultural or horticultural cooperatives.

(a) *Overview*—(1) *In general*. This section provides rules relating to the deduction for income attributable to domestic production activities of a specified agricultural or horticultural cooperative (Specified Cooperative). This paragraph (a) provides an overview and definitions of certain terms. Paragraph (b) of this section provides rules explaining the steps a nonexempt Specified Cooperative performs to calculate its section 199A(g) deduction and includes definitions of relevant terms. Paragraph (c) of this section provides rules explaining the steps an exempt Specified Cooperative performs to calculate its section 199A(g) deduction. Paragraph (d) of this section provides rules for Specified Cooperatives passing through the section 199A(g) deduction to patrons. Paragraph (e) of this section provides examples that illustrate the provisions of paragraphs (b), (c), and (d) of this section. Paragraph (f) of this section provides guidance for Specified Cooperatives that are partners in a partnership. Paragraph (g) of this section provides guidance on the recapture of a claimed section 199A(g) deduction. Paragraph (h) of this section provides effective dates. For additional rules addressing an expanded affiliated group (EAG) *see* §1.199A-12. The principles of this section apply to the EAG rules in §1.199A-12.

(2) *Specified Cooperative*—(i) *In general*. Specified Cooperative means a cooperative to which Part I of subchapter T of chapter 1 of subtitle A of the Internal Revenue Code (Code) applies and which—

(A) 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.

(ii) *Additional rules*. See §1.199A-9 for rules to determine if a Specified Cooperative has MPGE an agricultural or horticultural product in whole or significant part within the United States.

(iii) *Types of Specified Cooperatives*. A Specified Cooperative that is qualified as a farmer's cooperative organization under section 521 is an *exempt Specified Cooperative*, while a Specified Cooperative not so qualified is a *nonexempt Specified Cooperative*.

(3) *Patron* is defined in §1.1388-1(e).

(4) *Agricultural or horticultural products* are agricultural, horticultural, viticultural, and dairy products, livestock and the products thereof, the products of poultry and bee raising, the edible products of forestry, and any and all products raised or produced on farms and processed or manufactured products thereof within the meaning of the Cooperative Marketing Act of 1926, 44 Stat. 802 (1926). Agricultural or horticultural products also include aquatic products that are farmed whether by an exempt or a nonexempt Specified Cooperative. In addition, agricultural or horticultural products include fertilizer, diesel fuel, and other supplies used in agricultural or horticultural production that are MPGE by a Specified Cooperative. Agricultural or horticultural products, however, do not include intangible property (other than as provided in the exception in §1.199A-9(b)(2)); for example, an agricultural or horticultural product includes a seed that is grown, but does not include the intangible property right to reproduce a seed for sale. This exclusion of intangible property does not apply to intangible characteristics of any particular agricultural or horticultural product. For example, gross receipts from the sale of different varieties of oranges would all qualify as DPGR from the disposition of agricultural or horticultural products (assuming all other requirements of section 199A(g) are met). However, gross receipts from the license of the right to produce and sell a certain variety of an orange would be considered separate from the orange and not from an agricultural or horticultural product.

(b) *Steps for a nonexempt Specified Cooperative in calculating deduction*—(1) *In general*. Except as provided in paragraph (c)(3) of this section, this paragraph (b) applies only to nonexempt Specified Cooperatives.

(2) *Step 1 - Gross receipts and related deductions*—(i) *Identify*. To determine the section 199A(g) deduction, a Specified Cooperative first identifies its patronage and nonpatronage gross receipts and related cost of goods sold (COGS), deductible expenses, W-2 wages, etc. (deductions) and allocates them between patronage and nonpatronage. A single definition for the term *patronage and nonpatronage* is found in §1.1388-1(f).

(ii) *Applicable gross receipts and deductions*. For all purposes of the section 199A(g) deduction, a Specified Cooperative can use only patronage gross receipts and related deductions to calculate qualified production activities income (QPAI) as defined in paragraph (b)(4)(ii) of this section, oil-related QPAI as defined in paragraph (b)(7)(ii) of this section, or the W-2 wage limitation in paragraph (b)(5)(ii)(B) of this section. A Specified Cooperative cannot use its nonpatronage gross receipts and related deductions to calculate its section 199A(g) deduction.

(iii) *Gross receipts* are the Specified Cooperative's receipts for the taxable year that are recognized under the Specified Cooperative's methods of accounting used for Federal income tax purposes for the taxable year. See §1.199A-12 if the gross receipts are recognized in an intercompany transaction within the meaning of §1.1502-13. Gross receipts include total sales (net of returns and allowances) and all amounts received for services. In addition, gross receipts include any income from investments and from incidental or outside sources. For example, gross receipts include interest (except interest under section 103 but including original issue discount), dividends, rents, royalties, and annuities, regardless of whether the amounts are derived in the ordinary course of the Specified Cooperative's trade or business. Gross receipts are not reduced by COGS or by the cost of property sold if such property is described in section 1221(a)(1), (2), (3), (4), or (5). Finally, gross receipts do not include amounts received by the Specified Cooperative with respect to sales tax or other similar state or local taxes if, under the applicable state or local law, the tax is legally imposed on the purchaser of the good or service and the Specified Cooperative merely collects and remits the tax to the taxing authority. If, in contrast, the tax is imposed on the Specified Cooperative under the applicable law, then gross receipts include the amounts received that are allocable to the payment of such tax.

(3) *Step 2 – Determine gross receipts that are DPGR*—(i) *In general*. A Specified Cooperative examines its patronage gross receipts to determine which of these are DPGR. A Specified Cooperative does not use nonpatronage gross receipts to determine DPGR.

(ii) *DPGR* are the gross receipts of the Specified Cooperative that are derived from any lease, rental, license, sale, exchange, or other disposition of an agricultural or horticultural product that is MPGE by the Specified Cooperative or its patrons in whole or significant part within the United States. DPGR does not include gross receipts derived from services or the lease, rental, license, sale, exchange, or other disposition of land unless a de minimis or other exception applies. See §1.199A-9 for additional rules on determining if gross receipts are DPGR.

(4) *Step 3 – Determine QPAI*—(i) *In general*. A Specified Cooperative determines QPAI from patronage DPGR and patronage deductions identified in paragraphs (b)(3)(ii) and (b)(2)(i) of this section, respectively. A Specified Cooperative does not use nonpatronage gross receipts or deductions to determine QPAI.

(ii) *QPAI* for the taxable year means an amount equal to the excess (if any) of—

(A) DPGR for the taxable year, over

(B) The sum of—

(*1*) COGS that are allocable to DPGR, and

(*2*) Other expenses, losses, or deductions (other than the section 199A(g) deduction) that are properly allocable to DPGR.

(C) *QPAI computational rules*. QPAI is computed without taking into account the section 199A(g) deduction or any deduction allowed under section 1382(b). *See* §1.199A-10 for additional rules on calculating QPAI.

(5) *Step 4 – Calculate deduction*—(i) *In general*. From QPAI and taxable income, a Specified Cooperative calculates its section 199A(g) deduction as provided in paragraph (b)(5)(ii) of this section.

(ii) *Deduction*—(A) *In general*. A Specified Cooperative is allowed a deduction equal to 9 percent of the lesser of—

(*1*) QPAI of the Specified Cooperative for the taxable year, or

(*2*) Taxable income of the Specified Cooperative for the taxable year.

(B) *W-2 wage limitation*. The deduction allowed under paragraph (b)(5)(ii)(A) of this section for any taxable year cannot exceed 50 percent of the patronage W-2 wages attributable to DPGR for the taxable year. *See* §1.199A-11 for additional rules on calculating the patronage W-2 wage limitation.

(C) *Taxable income*. Taxable income is defined in section 1382 and §1.1382-1 and §1.1382-2. For purposes of determining the amount of the deduction allowed under paragraph (b)(5)(ii) of this section, taxable income is limited to taxable income and related deductions from patronage sources. Patronage net operating losses (NOLs) reduce taxable income. Taxable income is computed without taking into account the section 199A(g) deduction or any deduction allowable under section 1382(b). Taxable income is determined using the same method of accounting used to determine distributions under section 1382(b) and qualified payments to eligible taxpayers.

(6) *Use of patronage section 199A(g) deduction*. Except as provided in §1.199A-12(c)(2) related to the rules for EAGs, the patronage section 199A(g) deduction cannot create or increase a patronage or nonpatronage NOL or the amount of a patronage or nonpatronage NOL carryover or carryback, if applicable, in accordance with section 172. A patronage section 199A(g) deduction can be applied only against patronage income and deductions. A patronage section 199A(g) deduction that is not used in the appropriate taxable year is lost.

(7) *Special rules for nonexempt Specified Cooperatives that have oil-related QPAI*—(i) *Reduction of section 199A(g) deduction*. If a Specified Cooperative has oil-related QPAI for any taxable year, the amount otherwise allowable as a deduction under paragraph (b)(5)(ii) of this section must be reduced by 3 percent of the least of—

(A) Oil-related QPAI of the Specified Cooperative for the taxable year,

(B) QPAI of the Specified Cooperative for the taxable year, or

(C) Taxable income of the Specified Cooperative for the taxable year.

(ii) *Oil-related QPAI* means, for any taxable year, the patronage QPAI that is attributable to the production, refining, processing, transportation, or distribution of oil, gas, or any primary product thereof (within the meaning of section 927(a)(2)(C), as in effect before its repeal) during such taxable year. Oil-related QPAI for any taxable year is an amount equal to the excess (if any) of patronage DPGR derived from the production, refining or processing of oil, gas, or any primary product thereof (oil-related DPGR) over the sum of—

(A) COGS of the Specified Cooperative that is allocable to such receipts; and

(B) Other expenses, losses, or deductions (other than the section 199A(g) deduction) that are properly allocable to such receipts.

(iii) *Special rule for patronage oil-related DPGR*. Oil-related DPGR does not include gross receipts derived from the transportation or distribution of oil, gas, or any primary product thereof. However, to the extent that the nonexempt Specified Cooperative treats gross receipts derived from transportation or distribution of oil, gas, or any primary product thereof as part of DPGR under §1.199A-9(j)(3)(i), or under §1.199A-9(j)(3)(i)(B), then the Specified Cooperative must treat those patronage gross receipts as oil-related DGPR.

(iv) *Oil* includes oil recovered from both conventional and non-conventional recovery methods, including crude oil, shale oil, and oil recovered from tar/oil sands. The *primary product from oil* includes all products derived from the destructive distillation of oil, including volatile products, light oils such as motor fuel and kerosene, distillates such as naphtha, lubricating oils, greases and waxes, and residues such as fuel oil. The *primary product from gas* means all gas and associated hydrocarbon components from gas wells or oil wells, whether recovered at the lease or upon further processing, including natural gas, condensates, liquefied petroleum gases such as ethane, propane, and butane, and liquid products such as natural gasoline. The primary products from oil and gas provided in this paragraph (b)(7)(iv) are not intended to represent either the only primary products from oil or gas, or the only processes from which primary products may be derived under existing and future technologies. Examples of non-primary products include, but are not limited to, petrochemicals, medicinal products, insecticides, and alcohols.

(c) *Exempt Specified Cooperatives*—(1) *In general*. This paragraph (c) applies only to exempt Specified Cooperatives.

(2) *Two section 199A(g) deductions*. The Specified Cooperative must calculate two separate section 199A(g) deductions, one patronage sourced and the other nonpatronage sourced. Patronage and nonpatronage gross receipts, related COGS that are allocable to DPGR, and other expenses, losses, or deductions (other than the section 199A(g) deduction) that are properly allocable to DPGR (deductions), DPGR, QPAI, NOLs, W-2 wages, etc. are not netted to calculate these two separate section 199A(g) deductions.

(3) *Exempt Specified Cooperative patronage section 199A(g) deduction*. The Specified Cooperative calculates its patronage section 199A(g) deduction following steps 1 through 4 in paragraphs (b)(2) through (5) of this section as if it were a nonexempt Specified Cooperative.

(4) *Exempt Specified Cooperative nonpatronage section 199A(g) deduction*—(i) *In general*. The Specified Cooperative calculates its nonpatronage section 199A(g) deduction following steps 2 through 4 in paragraphs (b)(2) through (5) of this section using only nonpatronage gross receipts and related nonpatronage deductions. For purposes of determining the amount of the nonpatronage section 199A(g) deduction allowed under paragraph (b)(5)(ii) of this section, taxable income is limited to taxable income and related deductions from nonpatronage sources. Nonpatronage NOLs reduce taxable income. Taxable income is computed without taking into account the section 199A(g) deduction or any deduction allowable under section 1382(c). Taxable income is determined using the same method of accounting used to determine distributions under section 1382(c)(2).

(ii) *Use of nonpatronage section 199A(g) deduction*. Except as provided in §1.199A-12(c)(2) related to the rules for EAGs, the nonpatronage section 199A(g) deduction cannot create or increase a nonpatronage NOL or the amount of nonpatronage NOL carryover or carryback, if applicable, in accordance with section 172. A Specified Cooperative cannot allocate its nonpatronage section 199A(g) deduction under paragraph (d) of this section and can apply the nonpatronage section 199A(g) deduction only against its nonpatronage income and deductions. As is the case for the patronage section 199A(g) deduction, the nonpatronage section 199A(g) deduction that a Specified Cooperative does not use in the appropriate taxable year is lost.

(d) *Discretion to pass through deduction*—(1) *In general*. A Specified Cooperative may, at its discretion, pass through all, some, or none of its patronage section 199A(g) deduction to an eligible taxpayer. An eligible taxpayer is a patron other than a C corporation or a Specified Cooperative. A Specified Cooperative member of a federated cooperative may pass through the patronage section 199A(g) deduction it receives from the federated cooperative to its member patrons that are eligible taxpayers.

(2) *Amount of deduction being passed through*—(i) *In general*. A Specified Cooperative is permitted to pass through to an eligible taxpayer an amount equal to the portion of the Specified Cooperative's section 199A(g) deduction that is allowed with respect to the portion of the cooperative's QPAI that is attributable to the qualified payments the Specified Cooperative distributed to the eligible taxpayer during the taxable year and identified on the notice required in §1.199A-7(f)(3) on an attachment to or on the Form 1099-PATR, Taxable Distributions Received From Cooperatives (Form 1099-PATR), (or any successor form) issued by the Specified Cooperative to the eligible taxpayer, unless otherwise provided by the instructions to the Form. The notice requirement to pass through the section 199A(g) deduction is in paragraph (d)(3) of this section.

(ii) *Qualified payment* means any amount of a patronage dividend or per-unit retain allocation, as described in section 1385(a)(1) or (3) received by a patron from a Specified Cooperative that is attributable to the portion of the Specified Cooperative's QPAI, for which the cooperative is allowed a section 199A(g) deduction. For this purpose, patronage dividends include any advances on patronage and per-unit retain allocations include per-unit retains paid in money during the taxable year. A Specified Cooperative calculates its qualified payment using the same method of accounting it uses to calculate its taxable income.

(3) *Notice requirement to pass through deduction*. A Specified Cooperative must identify in a written notice the amount of the section 199A(g) deduction being passed through to the eligible taxpayer. This written notice must be mailed by the Specified Cooperative to the eligible taxpayer no later than the 15th day of the ninth month following the close of the taxable year of the Specified Cooperative. The Specified Cooperative may use the same written notice, if any, that it uses to notify the eligible taxpayer of the eligible taxpayer's respective allocations of patronage distributions, or may use a separate timely written notice(s) to comply with this section. The Specified Cooperative must report the amount of section 199A(g) deduction passed through to the eligible taxpayer on an attachment to or on the Form 1099-PATR (or any successor form) issued by the Specified Cooperative to the eligible taxpayer, unless otherwise provided by the instructions to the Form.

(4) *Section 199A(g) deduction allocated to eligible taxpayer*. An eligible taxpayer may deduct the lesser of the section 199A(g) deduction identified on the notice described in paragraph (d)(3) of this section or the eligible taxpayer's taxable income in the taxable year in which the eligible taxpayer receives the timely written notice described in paragraph (d)(3) of this section. For this purpose, the eligible taxpayer's taxable income is determined without taking into account the section 199A(g) deduction being passed through to the eligible taxpayer and after taking into account any section 199A(a) deduction allowed to the eligible taxpayer. Any section 199A(g) deduction the eligible taxpayer does not use in the taxable year in which the eligible taxpayer receives the notice (received on or before the due date of the Form 1099-PATR) is lost and cannot be carried forward or back to other taxable years. The taxable income limitation for the section 199A(a) deduction set forth in section 199A(b)(3) and §1.199A-1(a) and (b) does not apply to limit the deductibility of the sec-

tion 199A(g) deduction passed through to the eligible taxpayer.

(5) *Special rules for eligible taxpayers that are Specified Cooperatives*. A Specified Cooperative that receives a section 199A(g) deduction as an eligible taxpayer can take the deduction only against patronage gross income and related deductions.

(6) *W-2 wage limitation*. The W-2 wage limitation described in paragraph (b)(5)(ii)(B) of this section is applied at the cooperative level whether or not the Specified Cooperative chooses to pass through some or all of the section 199A(g) deduction. Any section 199A(g) deduction that has been passed through by a Specified Cooperative to an eligible taxpayer is not subject to the W-2 wage limitation a second time at the eligible taxpayer's level.

(7) *Specified Cooperative denied section 1382 deduction for portion of qualified payments*. A Specified Cooperative must reduce its section 1382 deduction under section 1382(b) and/or (c), as applicable) by an amount equal to the portion of any qualified payment that is attributable to the Specified Cooperative's section 199A(g) deduction passed through to the eligible taxpayer. This means the Specified Cooperative must reduce its section 1382 deduction in an amount equal to the section 199A(g) deduction passed through to its eligible taxpayers.

(8) *No double counting*. A qualified payment received by a Specified Cooperative that is a patron of a Specified Cooperative is not taken into account by the patron for purposes of section 199A(g).

(e) *Examples*. The following examples illustrate the application of paragraphs (b), (c), and (d) of this section. Assume for each example that the Specified Cooperative sent all required notices to patrons on or before the due date of the Form 1099-PATR.

(1) *Example 1. Nonexempt Specified Cooperative calculating section 199A(g) deduction*. (i) C is a grain marketing nonexempt Specified Cooperative, with $5,250,000 in gross receipts during 2018 from the sale of grain grown by its patrons. C paid $4,000,000 to its patrons at the time the grain was delivered in the form of per-unit retain allocations pursuant to an agreement and another $1,000,000 in patronage dividends after the close of the 2018 taxable year. C has other expenses of $250,000 during 2018, including $100,000 of W-2 wages.

(ii) C has DPGR of $5,250,000 and QPAI as defined in §1.199A-8(b)(4)(ii) of $5,000,000 for 2018. C's section 199A(g) deduction is equal to the least of 9% of QPAI ($450,000), 9% of taxable income ($450,000), or 50% of W-2 wages ($50,000). C passes through the entire section 199A(g) deduction to its patrons. Accordingly, C reduces its $5,000,000 deduction allowable under section 1382(b) (relating to the $1,000,000 patronage dividends and $4,000,000 per-unit retain allocations) by $50,000.

(2) *Example 2. Nonexempt Specified Cooperative calculating section 199A(g) deduction with purchases*. Same facts as *Example 1*, except C purchased grain from its patrons for $4,000,000 and these purchases are not per-unit retain allocations described in section 1388(f). C allocated and reported the $1,000,000 patronage dividends to its patrons and provided notification (in accordance with the requirements of §1.199A-7(f)(3)) that only the patronage dividends are treated as qualified payments for purposes of its section 199A(g) deduction. C has QPAI and taxable income of $1,000,000 ($5,250,000 – $4,000,000 – $250,000). C's section 199A(g) deduction is the lesser of 9% of QPAI ($90,000), 9% of taxable income without taking into account any deduction under section 1382(b) ($90,000), or 50% of W-2 wages ($50,000). C passes through the entire section 199A(g) deduction to its patrons. Accordingly, C reduces its $1,000,000 deduction allowable under section 1382(b) by $50,000. Patrons do not include any of the $4,000,000 of payments when determining the reduction amount under section 199A(b)(7).

(3) *Example 3. Nonexempt Specified Cooperative determines amounts included in QPAI and taxable income*. (i) C, a nonexempt Specified Cooperative, offers harvesting services and markets the grain of patrons and nonpatrons. C had gross receipts from harvesting services and grain sales, and expenses related to both. All of C's harvesting services were performed for their patrons, and 75% of the grain sales were for patrons.

(ii) C identifies 75% of the gross receipts and related expenses from grain sales and 100% of the gross receipts and related expenses from the harvesting services as patronage sourced. C identifies 25% of the gross receipts and related expenses from grain sales as nonpatronage sourced.

(iii) C does not include any nonpatronage gross receipts or related expenses from grain sales in either QPAI or taxable income when calculating the section 199A(g) deduction. C's QPAI includes the patronage DPGR, less related expenses (allocable COGS, wages and other expenses). C's taxable income includes the patronage gross receipts, whether such gross receipts are DPGR or non-DPGR.

(iv) C allocates and reports patronage dividends to its harvesting patrons and grain marketing patrons. C also notifies its grain marketing patrons (in accordance with the requirements of §1.199A-7(f)(3)) that their patronage dividends are qualified payments used in C's section 199A(g) computation. The patrons must use this information for purposes of computing their section 199A(b)(7) reduction to their section 199A(a) deduction (*see* §1.199A-7(f)).

(4) *Example 4. Nonexempt Specified Cooperative with patronage and nonpatronage gross receipts and related deductions*. (i) C, a nonexempt Specified Cooperative, markets corn grown by its patrons in the United States. For the calendar year ending December 31, 2020, C derives gross receipts from the marketing activity of $1,800. Such gross receipts qualify as DPGR. Assume C has $800 of expenses (including COGS, other expenses, and $400 of W-2 wages) properly allocable to DPGR, and a $1,000 deduction allowed under section 1382(b). C also derives gross receipts from nonpatronage sources in the amount of $500, and has nonpatronage deductions in the amount of $400 (including COGS, other expenses, and $100 of W-2 wages).

(ii) C does not include any gross receipts or deductions from nonpatronage sources when calculating the deduction under paragraph (b)(5)(ii) of this section. C's QPAI and taxable income both equal $1,000 ($1,800 – 800). C's deduction under paragraph (b)(5)(ii) of this section for the taxable year is equal to $90 (9% of $1,000), which does not exceed $200 (50% of C's W-2 wages properly allocable to DPGR). C passes through $90 of the deduction to patrons and C reduces its section 1382(b) deduction by $90.

(5) *Example 5. Exempt Specified Cooperative with patronage and nonpatronage income and deductions*. (i) C, an exempt Specified Cooperative, markets corn MPGE by its patrons in the United States. For the calendar year ending December 31, 2020, C derives gross receipts from the marketing activity of $1,800. For this activity assume C has $800 of expenses (including COGS, other expenses, and $400 of W-2 wages) properly allocable to DPGR, and a $1,000 deduction under section 1382(b). C also derives gross receipts from nonpatronage sources in the amount of $500. Assume the gross receipts qualify as DPGR. For this activity assume C has $400 of expenses (including COGS, other expenses, and $20 of W-2 wages) properly allocable to DPGR and no deduction under section 1382(c).

(ii) C calculates two separate section 199A(g) deduction amounts. C's section 199A(g) deduction attributable to patronage sources is the same as the deduction calculated by the nonexempt Specified Cooperative in *Example 1* in paragraph (e)(1) of this section.

(iii) C's nonpatronage QPAI and taxable income is equal to $100 ($500 – $400). C's deduction under paragraph (c)(3) of this section that directs C to use paragraph (b)(5)(ii) of this section attributable to nonpatronage sources is equal to $9 (9% of $100), which does not exceed $10 (50% of C's W-2 wages properly allocable to DPGR). C cannot pass through any of the nonpatronage section 199A(g) deduction amount to its patrons.

(6) *Example 6. NOL*. C, a nonexempt Specified Cooperative, MPGE agricultural or horticultural products. C is not part of an EAG as defined in §1.199A-12. In 2018, C generates QPAI and taxable income is $600, without taking into account any of its deductions under section 1382(b), the deduction under section 199A(g), or an NOL deduction. During 2018, C incurs W-2 wages as defined in §1.199A-11 of $300. C has an NOL carryover to 2018 of $500. C's deduction under this section for 2018 is $9 (9% × (lesser of QPAI of $600 and taxable income of $100 ($600 taxable income – $500 NOL)). Under these facts the wage limitation does not act to limit the deduction because the wage limitation is $150 (50% × $300).

(7) *Example 7. NOL*. (i) C, a nonexempt Specified Cooperative, MPGE agricultural or horticultural products. C is not part of an EAG. In 2018, C generates QPAI and taxable income of $100, without taking into account any of its deductions under section 1382(b), the deduction under section 199A(g), or an NOL deduction. C has an NOL carryover to 2018 of $500 that reduces its taxable income for 2018 to $0. C's section 199A(g) deduction for 2018 is $0 (9% × (lesser of QPAI of $100 and taxable income of $0)).

(ii) *Carryover to 2019*. C's taxable income for purposes of determining its NOL carryover to 2019 is $100. Accordingly, for purposes of section 199A(g), C's NOL carryover to 2019 is $400 ($500 NOL carryover to 2018 – $100 NOL used in 2018).

(f) *Special rule for Specified Cooperative partners*. In the case described in section 199A(g)(5)(B), where a Specified Cooperative is a partner in a partnership, the partnership must separately identify and report on the Schedule K-1 of the Form 1065, U.S. Return of Partnership Income (or any successor form) issued to the Specified Cooperative the cooperative's share of gross receipts and related deductions, unless otherwise provided by the instructions to the Form. The Specified Cooperative determines what gross receipts reported by the partnership qualify as DPGR and includes these gross receipts and related deductions to calculate one section 199A(g) deduction (in the case of a nonexempt Specified Cooperative) or two section 199A(g) deductions (in the case of an exempt Specified Cooperative) using the steps set forth in paragraphs (b) and (c) of this section.

(g) *Recapture of section 199A(g) deduction*. If the amount of the section 199A(g) deduction that was passed through to eligible taxpayers exceeds the amount allowable as a section 199A(g) deduction as determined on examination or reported on an amended return, then recapture of the excess will occur at the Specified Cooperative level in the taxable year the Specified Cooperative took the excess section 199A(g) deduction.

(h) *Applicability date*. Except as provided in paragraph (h)(2) of §1.199A-7, the provisions of this section apply to taxable years ending after the date the Treasury decision adopting these regulations as final regulations is published in the *Federal Register*. Taxpayers, however, may rely on these regulations until that date, but only if the taxpayers apply the rules in their entirety and in a consistent manner.

§1.199A-9 Domestic production gross receipts.

(a) *Domestic production gross receipts*—(1) *In general*. The provisions of this section apply solely for purposes of section 199A(g) of the Internal Revenue Code (Code). The provisions of this section provide guidance to determine what gross receipts (defined in §1.199A-8(b)(2)(iii)) are domestic production gross receipts (DPGR) (defined in §1.199A-8(b)(3)(ii)). DPGR does not include gross receipts derived from services or the lease, rental, license, sale, exchange, or other disposition of land unless a de minimis or other exception applies. Partners, including partners in an EAG partnership described in §1.199A-12(i)(1), may not treat guaranteed payments under section 707(c) as DPGR.

(2) *Application to marketing cooperatives*. For purposes of determining DPGR, a Specified Cooperative (defined in §1.199A-8(a)(2)) will be treated as having manufactured, produced, grown, or extracted (MPGE) (defined in paragraph (f) of this section) in whole or significant part (defined in paragraph (h) of this section) any agricultural or horticultural product (defined in §1.199A-8(a)(4)) within the United States (defined in paragraph (i) of this section) marketed by the Specified Cooperative which its patrons (defined in §1.1388-1(e)) have so MPGE.

(b) *Related persons*—(1) *In general*. Pursuant to 199A(g)(3)(D)(ii), DPGR does not include any gross receipts derived from agricultural or horticultural products leased, licensed, or rented by the Specified Cooperative for use by any related person. A person is treated as related to another person if both persons are treated as a single employer under either section 52(a) or (b) (without regard to section 1563(b)), or section 414(m) or (o). Any other person is an unrelated person for purposes of the section 199A(g) deduction.

(2) *Exceptions*. Notwithstanding paragraph (b)(1) of this section, gross receipts derived from any agricultural or horticultural product leased or rented by the Specified Cooperative to a related person may qualify as DPGR if the agricultural or horticultural product is held for sublease or rent, or is subleased or rented, by the related person to an unrelated person for the ultimate use of the unrelated person. Similarly, notwithstanding paragraph (b)(1) of this section, gross receipts derived from a license of the right to reproduce an agricultural or horticultural product to a related person for reproduction and sale, exchange, lease, or rental to an unrelated person for the ultimate use of the unrelated person are treated as gross receipts from a disposition of an agricultural or horticultural product and may qualify as DPGR.

(c) *Allocating gross receipts*—(1) *In general*. A Specified Cooperative must determine the portion of its gross receipts for the taxable year that is DPGR and the portion of its gross receipts that is non-DPGR using a reasonable method based on all the facts and circumstances. Applicable Federal income tax principles apply to determine whether a transaction is, in substance, a lease, rental, license, sale, exchange, or other disposition the gross receipts of which may constitute DPGR, whether it is a service the gross receipts of which may constitute non-DPGR, or some combination thereof. For example, if a Specified Cooperative sells an agricultural or horticultural product and, in connection with that sale, also provides services, the Specified Cooperative must allocate its gross receipts from the transaction using a reasonable method based on all the facts and circumstances that accurately identifies the gross receipts that constitute DPGR and non-DPGR in accordance with the requirements of §§1.199A-8(b) and/or (c). The chosen reasonable method must be consistently applied from one taxable year to another and must clearly reflect the portion of gross receipts for the taxable year that is DPGR and the portion of gross receipts that is non-DPGR. The books and records maintained for gross receipts must be consistent with any allocations under this paragraph (c)(1).

(2) *Reasonable method of allocation*. If a Specified Cooperative has the information readily available and can, without undue burden or expense, specifically identify whether the gross receipts are derived from an item (and thus, are DPGR), then the Specified Cooperative must use that specific identification to determine DPGR. If the Specified Cooperative does not have information readily available to specifically identify whether gross receipts are derived from

an item or cannot, without undue burden or expense, specifically identify whether gross receipts are derived from an item, then the Specified Cooperative is not required to use a method that specifically identifies whether the gross receipts are derived from an item but can use a reasonable allocation method. Factors taken into consideration in determining whether the Specified Cooperative's method of allocating gross receipts between DPGR and non-DPGR is reasonable include whether the Specified Cooperative uses the most accurate information available; the relationship between the gross receipts and the method used; the accuracy of the method chosen as compared with other possible methods; whether the method is used by the Specified Cooperative for internal management or other business purposes; whether the method is used for other Federal or state income tax purposes; the time, burden, and cost of using alternative methods; and whether the Specified Cooperative applies the method consistently from year to year.

(3) *De minimis rules*—(i) *DPGR*. A Specified Cooperative's applicable gross receipts as provided in §§1.199A-8(b) and/or (c) may be treated as DPGR if less than 5 percent of the Specified Cooperative's total gross receipts are non-DPGR (after application of the exceptions provided in §1.199A-9(j)(3)). If the amount of the Specified Cooperative's gross receipts that are non-DPGR equals or exceeds 5 percent of the Specified Cooperative's total gross receipts, then, except as provided in paragraph (c)(3)(ii) of this section, the Specified Cooperative is required to allocate all gross receipts between DPGR and non-DPGR in accordance with paragraph (c)(1) of this section. If a Specified Cooperative is a member of an expanded affiliated group (EAG) (defined in §1.199A-12), but is not a member of a consolidated group, then the determination of whether less than 5 percent of the Specified Cooperative's total gross receipts are non-DPGR is made at the Specified Cooperative level. If a Specified Cooperative is a member of a consolidated group, then the determination of whether less than 5 percent of the Specified Cooperative's total gross receipts are non-DPGR is made at the consolidated group level. *See* §1.199A-12(d).

(ii) *Non-DPGR*. A Specified Cooperative's applicable gross receipts as provided in §§1.199A-8(b) and/or (c) may be treated as non-DPGR if less than 5 percent of the Specified Cooperative's total gross receipts are DPGR. If a Specified Cooperative is a member of an EAG, but is not a member of a consolidated group, then the determination of whether less than 5 percent of the Specified Cooperative's total gross receipts are DPGR is made at the Specified Cooperative level. If a Specified Cooperative is a member of a consolidated group, then the determination of whether less than 5 percent of the Specified Cooperative's total gross receipts are DPGR is made at the consolidated group level.

(d) *Use of historical data for multiple-year transactions*. If a Specified Cooperative recognizes and reports gross receipts from upfront payments or other similar payments on a Federal income tax return for a taxable year, then the Specified Cooperative's use of historical data in making an allocation of gross receipts from the transaction between DPGR and non-DPGR may constitute a reasonable method. If a Specified Cooperative makes allocations using historical data, and subsequently updates the data, then the Specified Cooperative must use the more recent or updated data, starting in the taxable year in which the update is made.

(e) *Determining DPGR item-by-item*—(1) *In general*. For purposes of the section 199A(g) deduction, a Specified Cooperative determines, using a reasonable method based on all the facts and circumstances, whether gross receipts qualify as DPGR on an item-by-item basis (and not, for example, on a division-by-division, product line-by-product line, or transaction-by-transaction basis). The chosen reasonable method must be consistently applied from one taxable year to another and must clearly reflect the portion of gross receipts that is DPGR. The books and records maintained for gross receipts must be consistent with any allocations under this paragraph (e)(1).

(i) The term *item* means the agricultural or horticultural product offered by the Specified Cooperative in the normal course of its trade or business for lease, rental, license, sale, exchange, or other disposition (for purposes of this paragraph (e), collectively referred to as disposition) to customers, if the gross receipts from the disposition of such product qualify as DPGR; or

(ii) If paragraph (e)(1)(i) of this section does not apply to the product, then any component of the product described in paragraph (e)(1)(i) of this section is treated as the item, provided that the gross receipts from the disposition of the product described in paragraph (e)(1)(i) of this section that are attributable to such component qualify as DPGR. Each component that meets the requirements under this paragraph (e)(1)(ii) must be treated as a separate item and a component that meets the requirements under this paragraph (e)(1)(ii) may not be combined with a component that does not meet these requirements.

(2) *Special rules*. (i) For purposes of paragraph (e)(1)(i) of this section, in no event may a single item consist of two or more products unless those products are offered for disposition, in the normal course of the Specified Cooperative's trade or business, as a single item (regardless of how the products are packaged).

(ii) In the case of agricultural or horticultural products customarily sold by weight or by volume, the item is determined using the most common custom of the industry (for example, barrels of oil).

(3) *Exception*. If the Specified Cooperative MPGE agricultural or horticultural products within the United States that it disposes of, and the Specified Cooperative leases, rents, licenses, purchases, or otherwise acquires property that contains or may contain the agricultural or horticultural products (or a portion thereof), and the Specified Cooperative cannot reasonably determine, without undue burden and expense, whether the acquired property contains any of the original agricultural or horticultural products MPGE by the Specified Cooperative, then the Specified Cooperative is not required to determine whether any portion of the acquired property qualifies as an item for purposes of paragraph (e)(1) of this section. Therefore, the gross receipts derived from the disposition of the acquired property may be treated as non-DPGR. Similarly, the preceding sentences apply if the Specified Cooperative can reasonably determine that the acquired property contains agricultural or horticultural products (or a

portion thereof) MPGE by the Specified Cooperative, but cannot reasonably determine, without undue burden or expense, how much, or what type, grade, etc., of the agricultural or horticultural MPGE by the Specified Cooperative the acquired property contains.

(f) *Definition of manufactured, produced, grown, or extracted (MPGE)*—(1) *In general*. Except as provided in paragraphs (f)(2) and (3) of this section, the term *MPGE* includes manufacturing, producing, growing, extracting, installing, developing, improving, and creating agricultural or horticultural products; making agricultural or horticultural products out of material by processing, manipulating, refining, or changing the form of an article, or by combining or assembling two or more articles; cultivating soil, raising livestock, and farming aquatic products. The term MPGE also includes storage, handling, or other processing activities (other than transportation activities) within the United States related to the sale, exchange, or other disposition of agricultural or horticultural products only if the products are consumed in connection with or incorporated into the MPGE of agricultural or horticultural products, whether or not by the Specified Cooperative. The Specified Cooperative (or the patron if section 1.199A-9(a)(2) applies) must have the benefits and burdens of ownership of the agricultural or horticultural products under Federal income tax principles during the period the MPGE activity occurs in order for the gross receipts derived from the MPGE of the agricultural or horticultural products to qualify as DPGR.

(2) *Packaging, repackaging, or labeling*. If the Specified Cooperative packages, repackages, or labels agricultural or horticultural products and engages in no other MPGE activity with respect to those agricultural or horticultural products, the packaging, repackaging, or labeling does not qualify as MPGE with respect to those agricultural or horticultural products.

(3) *Installing*. If a Specified Cooperative installs agricultural or horticultural products and engages in no other MPGE activity with respect to the agricultural or horticultural products, the Specified Cooperative's installing activity does not qualify as an MPGE activity. Notwithstanding paragraph (j)(3)(i)(A) of this section, if the Specified Cooperative installs agricultural or horticultural products MPGE by the Specified Cooperative and the Specified Cooperative has the benefits and burdens of ownership of the agricultural or horticultural products under Federal income tax principles during the period the installing activity occurs, then the portion of the installing activity that relates to the agricultural or horticultural products is an MPGE activity.

(4) *Consistency with section 263A*. A Specified Cooperative that has MPGE agricultural or horticultural products for the taxable year must treat itself as a producer under section 263A with respect to the agricultural or horticultural products unless the Specified Cooperative is not subject to section 263A. A Specified Cooperative that currently is not properly accounting for its production activities under section 263A, and wishes to change its method of accounting to comply with the producer requirements of section 263A, must follow the applicable administrative procedures issued under §1.446-1(e)(3)(ii) for obtaining the Commissioner's consent to a change in accounting method (for further guidance, for example, *see* Rev. Proc. 2015-13, 2015-5 IRB 419, or any applicable subsequent guidance (*see* §601.601(d)(2) of this chapter)).

(g) *By the taxpayer*. With respect to the exception of the rules applicable to an EAG and EAG partnerships under §1.199A-12, only one Specified Cooperative may claim the section 199A(g) deduction with respect to any qualifying activity under paragraph (f) of this section performed in connection with the same agricultural or horticultural product. If an unrelated party performs a qualifying activity under paragraph (f) of this section pursuant to a contract with a Specified Cooperative (or its patron as relevant under paragraph (a)(2) of this section), then only if the Specified Cooperative (or its patron) has the benefits and burdens of ownership of the agricultural or horticultural product under Federal income tax principles during the period in which the qualifying activity occurs is the Specified Cooperative (or its patron) treated as engaging in the qualifying activity.

(h) *In whole or significant part defined*—(1) *In general*. Agricultural or horticultural products must be MPGE in whole or significant part by the Specified Cooperative (or its patrons in the case described in paragraph (a)(2) of this section) and in whole or significant part within the United States to qualify under section 199A(g)(3)(D)(i). If a Specified Cooperative enters into a contract with an unrelated person for the unrelated person to MPGE agricultural or horticultural products for the Specified Cooperative and the Specified Cooperative has the benefits and burdens of ownership of the agricultural or horticultural products under applicable Federal income tax principles during the period the MPGE activity occurs, then, pursuant to paragraph (g) of this section, the Specified Cooperative is considered to MPGE the agricultural or horticultural products under this section. The unrelated person must perform the MPGE activity on behalf of the Specified Cooperative in whole or significant part within the United States in order for the Specified Cooperative to satisfy the requirements of this paragraph (h)(1).

(2) *Substantial in nature*. Agricultural or horticultural products will be treated as MPGE in whole or in significant part by the Specified Cooperative (or its patrons in the case described in paragraph (a)(2) of this section) within the United States for purposes of paragraph (h)(1) of this section if the MPGE of the agricultural or horticultural products by the Specified Cooperative within the United States is substantial in nature taking into account all the facts and circumstances, including the relative value added by, and relative cost of, the Specified Cooperative's MPGE within the United States, the nature of the agricultural or horticultural products, and the nature of the MPGE activity that the Specified Cooperative performs within the United States. The MPGE of a key component of an agricultural or horticultural product does not, in itself, meet the substantial-in-nature requirement with respect to an agricultural or horticultural product under this paragraph (h)(2). In the case of an agricultural or horticultural product, research and experimental activities under section 174 and the creation of intangible assets are not taken into account in determining whether the MPGE of the agricultural or horticultural product is substantial in nature.

(3) *Safe harbor*—(i) *In general*. A Specified Cooperative (or its patrons in the case described in paragraph (a)(2) of this section) will be treated as having MPGE an agricultural or horticultural product in whole or in significant part within the United States for purposes of paragraph (h)(1) of this section if the direct labor and overhead of such Specified Cooperative to MPGE the agricultural or horticultural product within the United States account for 20 percent or more of the Specified Cooperative's COGS of the agricultural or horticultural product, or in a transaction without COGS (for example, a lease, rental, or license), account for 20 percent or more of the Specified Cooperative's unadjusted depreciable basis (as defined in paragraph (h)(3)(ii) of this section) in property included in the definition of agricultural or horticultural products. For Specified Cooperatives subject to section 263A, overhead is all costs required to be capitalized under section 263A except direct materials and direct labor. For Specified Cooperatives not subject to section 263A, overhead may be computed using a reasonable method based on all the facts and circumstances, but may not include any cost, or amount of any cost, that would not be required to be capitalized under section 263A if the Specified Cooperative were subject to section 263A. Research and experimental expenditures under section 174 and the costs of creating intangible assets are not taken into account in determining direct labor or overhead for any agricultural or horticultural product. In the case of agricultural or horticultural products, research and experimental expenditures under section 174 and any other costs incurred in the creation of intangible assets may be excluded from COGS or unadjusted depreciable basis for purposes of determining whether the Specified Cooperative meets the safe harbor under this paragraph (h)(3). For Specified Cooperatives not subject to section 263A, the chosen reasonable method to compute overhead must be consistently applied from one taxable year to another and must clearly reflect the Specified Cooperative's portion of overhead not subject to section 263A. The method must also be reasonable based on all the facts and circumstances. The books and records maintained for overhead must be consistent with any allocations under this paragraph (h)(3)(i).

(ii) *Unadjusted depreciable basis*. The term unadjusted depreciable basis means the basis of property for purposes of section 1011 without regard to any adjustments described in section 1016(a)(2) and (3). This basis does not reflect the reduction in basis for—

(A) Any portion of the basis the Specified Cooperative properly elects to treat as an expense under sections 179 or 179C; or

(B) Any adjustments to basis provided by other provisions of the Code and the regulations under the Code (for example, a reduction in basis by the amount of the disabled access credit pursuant to section 44(d)(7)).

(4) *Special rules*—(i) *Contract with an unrelated person*. If a Specified Cooperative enters into a contract with an unrelated person for the unrelated person to MPGE an agricultural or horticultural product within the United States for the Specified Cooperative, and the Specified Cooperative is considered to MPGE the agricultural or horticultural product pursuant to paragraph (f)(1) of this section, then, for purposes of the substantial-in-nature requirement under paragraph (h)(2) of this section and the safe harbor under paragraph (h)(3)(i) of this section, the Specified Cooperative's MPGE activities or direct labor and overhead must include both the Specified Cooperative's MPGE activities or direct labor and overhead to MPGE the agricultural or horticultural product within the United States as well as the MPGE activities or direct labor and overhead of the unrelated person to MPGE the agricultural or horticultural product within the United States under the contract.

(ii) *Aggregation*. In determining whether the substantial-in-nature requirement under paragraph (h)(2) of this section or the safe harbor under paragraph (h)(3)(i) of this section is met at the time the Specified Cooperative disposes of an agricultural or horticultural product—

(A) An EAG member must take into account all of the previous MPGE activities or direct labor and overhead of the other members of the EAG;

(B) An EAG partnership as defined in §1.199A-12(i)(1) must take into account all of the previous MPGE activities or direct labor and overhead of all members of the EAG in which the partners of the EAG partnership are members (as well as the previous MPGE activities of any other EAG partnerships owned by members of the same EAG); and

(C) A member of an EAG in which the partners of an EAG partnership are members must take into account all of the previous MPGE activities or direct labor and overhead of the EAG partnership (as well as those of any other members of the EAG and any previous MPGE activities of any other EAG partnerships owned by members of the same EAG).

(i) *United States defined*. For purposes of section 199A(g), the term *United States* includes the 50 states, the District of Columbia, the territorial waters of the United States, and the seabed and subsoil of those submarine areas that are adjacent to the territorial waters of the United States and over which the United States has exclusive rights, in accordance with international law, with respect to the exploration and exploitation of natural resources. Consistent with its definition in section 7701(a)(9), the term *United States* does not include possessions and territories of the United States or the airspace or space over the United States and these areas.

(j) *Derived from the lease, rental, license, sale, exchange, or other disposition*—(1) *In general*—(i) *Definition*. The term *derived from the lease, rental, license, sale, exchange, or other disposition* is defined as, and limited to, the gross receipts directly derived from the lease, rental, license, sale, exchange, or other disposition of agricultural or horticultural products even if the Specified Cooperative has already recognized receipts from a previous lease, rental, license, sale, exchange, or other disposition of the same agricultural or horticultural products. Applicable Federal income tax principles apply to determine whether a transaction is, in substance, a lease, rental, license, sale, exchange, or other disposition, whether it is a service, or whether it is some combination thereof.

(ii) *Lease income*. The financing and interest components of a lease of agricultural or horticultural products are considered to be derived from the lease of such agricultural or horticultural products. However, any portion of the lease income that is attributable to services or non-qualified property as defined in paragraph (j)(3) of this section is not derived from the lease of agricultural or horticultural products.

(iii) *Income substitutes*. The proceeds from business interruption insurance, governmental subsidies, and governmental payments not to produce are treated as gross receipts derived from the lease, rental, license, sale, exchange, or other disposition to the extent they are substitutes for gross receipts that would qualify as DPGR.

(iv) *Exchange of property*—(A) *Taxable exchanges*. The value of property received by the Specified Cooperative in a taxable exchange of agricultural or horticultural products MPGE in whole or in significant part by the Specified Cooperative within the United States is DPGR for the Specified Cooperative (assuming all the other requirements of this section are met). However, unless the Specified Cooperative meets all of the requirements under this section with respect to any additional MPGE by the Specified Cooperative of the agricultural or horticultural products received in the taxable exchange, any gross receipts derived from the sale by the Specified Cooperative of the property received in the taxable exchange are non-DPGR, because the Specified Cooperative did not MPGE such property, even if the property was an agricultural or horticultural product in the hands of the other party to the transaction.

(B) *Safe harbor*. For purposes of paragraph (j)(1)(iv)(A) of this section, the gross receipts derived by the Specified Cooperative from the sale of eligible property (as defined in paragraph (j)(1)(iv)(C) of this section) received in a taxable exchange, net of any adjustments between the parties involved in the taxable exchange to account for differences in the eligible property exchanged (for example, location differentials and product differentials), may be treated as the value of the eligible property received by the Specified Cooperative in the taxable exchange. For purposes of the preceding sentence, the taxable exchange is deemed to occur on the date of the sale of the eligible property received in the taxable exchange by the Specified Cooperative, to the extent the sale occurs no later than the last day of the month following the month in which the exchanged eligible property is received by the Specified Cooperative. In addition, if the Specified Cooperative engages in any further MPGE activity with respect to the eligible property received in the taxable exchange, then, unless the Specified Cooperative meets the in-whole-or-in-significant-part requirement under paragraph (h)(1) of this section with respect to the property sold, for purposes of this paragraph (j)(1)(iv)(B), the Specified Cooperative must also value the property sold without taking into account the gross receipts attributable to the further MPGE activity.

(C) *Eligible property*. For purposes of paragraph (j)(1)(iv)(B) of this section, eligible property is—

(*1*) Oil, natural gas, or petrochemicals, or products derived from oil, natural gas, or petrochemicals; or

(*2*) Any other property or product designated by publication in the Internal Revenue Bulletin (*see* § 601.601(d)(2)(ii)(b) of this chapter).

(*3*) For this purpose, the term *natural gas* includes only natural gas extracted from a natural deposit and does not include, for example, methane gas extracted from a landfill. In the case of natural gas, production activities include all activities involved in extracting natural gas from the ground and processing the gas into pipeline quality gas.

(2) *Hedging transactions*—(i) *In general*. For purposes of this section, if a transaction is a hedging transaction within the meaning of section 1221(b)(2)(A) and §1.1221-2(b), is properly identified as a hedging transaction in accordance with §1.1221-2(f), and the risk being hedged relates to property described in section 1221(a)(1) that gives rise to DPGR or to property described in section 1221(a)(8) that is consumed in an activity that gives rise to DPGR, then—

(A) In the case of a hedge of purchases of property described in section 1221(a)(1), income, deduction, gain, or loss on the hedging transaction must be taken into account in determining COGS;

(B) In the case of a hedge of sales of property described in section 1221(a)(1), income, deduction, gain, or loss on the hedging transaction must be taken into account in determining DPGR; and

(C) In the case of a hedge of purchases of property described in section 1221(a)(8), income, deduction, gain, or loss on the hedging transaction must be taken into account in determining DPGR.

(ii) *Allocation*. The income, deduction, gain and loss from hedging transactions described in paragraph (j)(2) of this section must be allocated between the patronage and nonpatronage (defined in §1.1388-1(f)) sourced income and related deductions of the Specified Cooperatives consistent with the cooperative's method for determining patronage and nonpatronage income and deductions.

(iii) *Effect of identification and nonidentification*. The principles of §1.1221-2(g) apply to a Specified Cooperative that identifies or fails to identify a transaction as a hedging transaction, except that the consequence of identifying as a hedging transaction a transaction that is not in fact a hedging transaction described in paragraph (j)(2) of this section, or of failing to identify a transaction that the Specified Cooperative has no reasonable grounds for treating as other than a hedging transaction described in paragraph (j)(2) of this section, is that deduction or loss (but not income or gain) from the transaction is taken into account under paragraph (j)(2) of this section.

(iv) *Other rules*. See §1.1221-2(e) for rules applicable to hedging by members of a consolidated group and §1.446-4 for rules regarding the timing of income, deductions, gains or losses with respect to hedging transactions.

(3) *Allocation of gross receipts to embedded services and non-qualified property*—(i) *Embedded services and non-qualified property*—(A) *In general*. Except as otherwise provided in paragraph (j)(3)(i)(B) of this section, gross receipts derived from the performance of services do not qualify as DPGR. In the case of an embedded service, that is, a service the price of which, in the normal course of the business, is not separately stated from the amount charged for the lease, rental, license, sale, exchange, or other disposition of agricultural or horticultural products, DPGR includes only the gross receipts derived from the lease, rental, license, sale, exchange, or other disposition of agricultural or horticultural products (assuming all the other requirements of this section

are met) and not any receipts attributable to the embedded service. In addition, DPGR does not include gross receipts derived from the lease, rental, license, sale, exchange, or other disposition of property that does not meet all of the requirements under this section (non-qualified property). The allocation of the gross receipts attributable to the embedded services or non-qualified property will be deemed to be reasonable if the allocation reflects the fair market value of the embedded services or non-qualified property.

(B) *Exceptions*. There are five exceptions to the rules under paragraph (j)(3)(i)(A) of this section regarding embedded services and non-qualified property. A Specified Cooperative may include in DPGR, if all the other requirements of this section are met with respect to the underlying item of agricultural or horticultural products to which the embedded services or non-qualified property relate, the gross receipts derived from—

(1) A qualified warranty, that is, a warranty that is provided in connection with the lease, rental, license, sale, exchange, or other disposition of agricultural or horticultural products if, in the normal course of the Specified Cooperative's business—

(i) The price for the warranty is not separately stated from the amount charged for the lease, rental, license, sale, exchange, or other disposition of the agricultural or horticultural products; and

(ii) The warranty is neither separately offered by the Specified Cooperative nor separately bargained for with customers (that is, a customer cannot purchase the agricultural or horticultural products without the warranty);

(2) A qualified delivery, that is, a delivery or distribution service that is provided in connection with the lease, rental, license, sale, exchange, or other disposition of agricultural or horticultural products if, in the normal course of the Specified Cooperative's business—

(i) The price for the delivery or distribution service is not separately stated from the amount charged for the lease, rental, license, sale, exchange, or other disposition of the agricultural or horticultural products; and

(ii) The delivery or distribution service is neither separately offered by the Specified Cooperative nor separately bargained for with customers (that is, a customer cannot purchase the agricultural or horticultural products without the delivery or distribution service).

(3) A qualified operating manual, that is, a manual of instructions that is provided in connection with the lease, rental, license, sale, exchange, or other disposition of the agricultural or horticultural products if, in the normal course of the Specified Cooperative's business—

(i) The price for the manual is not separately stated from the amount charged for the lease, rental, license, sale, exchange, or other disposition of the agricultural or horticultural products;

(ii) The manual is neither separately offered by the Specified Cooperative nor separately bargained for with customers (that is, a customer cannot purchase the agricultural or horticultural products without the manual); and

(iii) The manual is not provided in connection with a training course for customers.

(4) A qualified installation, that is, an installation service for agricultural or horticultural products that is provided in connection with the lease, rental, license, sale, exchange, or other disposition of the agricultural or horticultural products if, in the normal course of the Specified Cooperative's business—

(i) The price for the installation service is not separately stated from the amount charged for the lease, rental, license, sale, exchange, or other disposition of the agricultural or horticultural products; and

(ii) The installation is neither separately offered by the Specified Cooperative nor separately bargained for with customers (that is, a customer cannot purchase the agricultural or horticultural products without the installation service).

(5) A de minimis amount of gross receipts from embedded services and non-qualified property for each item of agricultural or horticultural products may qualify. For purposes of this exception, a de minimis amount of gross receipts from embedded services and non-qualified property is less than 5 percent of the total gross receipts derived from the lease, rental, license, sale, exchange, or other disposition of each item of agricultural or horticultural products. In the case of gross receipts derived from the lease, rental, license, sale, exchange, or other disposition of agricultural or horticultural products that are received over a period of time (for example, a multi-year lease or installment sale), this de minimis exception is applied by taking into account the total gross receipts for the entire period derived (and to be derived) from the lease, rental, license, sale, exchange, or other disposition of the item of agricultural or horticultural products. For purposes of the preceding sentence, if a Specified Cooperative treats gross receipts as DPGR under this de minimis exception, then the Specified Cooperative must treat the gross receipts recognized in each taxable year consistently as DPGR. The gross receipts that the Specified Cooperative treats as DPGR under paragraphs (j)(3)(i)(B)(1) through (4) of this section are treated as DPGR for purposes of applying this de minimis exception. This de minimis exception does not apply if the price of a service or non-qualified property is separately stated by the Specified Cooperative, or if the service or non-qualified property is separately offered or separately bargained for with the customer (that is, the customer can purchase the agricultural or horticultural products without the service or non-qualified property).

(ii) *Non-DPGR*. Applicable gross receipts as provided in §§1.199A-8(b) and/or (c) derived from the lease, rental, license, sale, exchange or other disposition of an item of agricultural or horticultural products may be treated as non-DPGR if less than 5 percent of the Specified Cooperative's total gross receipts derived from the lease, rental, license, sale, exchange or other disposition of that item are DPGR (taking into account embedded services and non-qualified property included in such disposition, but not part of the item). In the case of gross receipts derived from the lease, rental, license, sale, exchange, or other disposition of agricultural or horticultural products that are received over a period of time (for example, a multi-year lease or installment sale), this paragraph (j)(5)(ii) is applied by taking into account the total gross receipts for the entire period derived (and to be derived) from the lease, rental, license, sale, exchange, or other disposition of the item of agricultural or horticultural products. For purposes of the preceding sentence, if the Specified Cooperative treats gross receipts as non-DPGR under this de minimis exception, then the Specified Cooperative must treat the gross receipts recognized in each taxable year consistently as non-DPGR.

(k) *Applicability date*. The provisions of this section apply to taxable years ending after the date the Treasury decision adopting these regulations as final regulations is published in the *Federal Register*. Taxpayers, however, may rely on these regulations until that date, but only if the taxpayers apply the rules in their entirety and in a consistent manner.

§1.199A-10 Allocation of costs of goods sold (COGS) and other deductions to domestic production gross receipts (DPGR), and other rules.

(a) *In general*. The provisions of this section apply solely for purposes of section 199A(g) of the Internal Revenue Code (Code). The provisions of this section provide additional guidance on determining qualified production activities income (QPAI) as described and defined in §1.199A-8(b)(4)(ii).

(b) *COGS allocable to DPGR*—(1) *In general*. When determining its QPAI, the Specified Cooperative (defined in §1.199A-8(a)(2)) must subtract from its DPGR (defined in §1.199A-8(b)(3)(ii)) the COGS allocable to its DPGR. The Specified Cooperative determines its COGS allocable to DPGR in accordance with this paragraph (b)(1) or, if applicable, paragraph (f) of this section. In the case of a sale, exchange, or other disposition of inventory, COGS is equal to beginning inventory of the Specified Cooperative plus purchases and production costs incurred during the taxable year and included in inventory costs by the Specified Cooperative, less ending inventory of the Specified Cooperative. In determining its QPAI, the Specified Cooperative does not include in COGS any payment made, whether during the taxable year, or included in beginning inventory, for which a deduction is allowed under section 1382(b) and/or (c), as applicable. *See* §1.199A-8(b)(4)(C). COGS is determined under the methods of accounting that the Specified Cooperative uses to compute taxable income. *See* sections 263A, 471, and 472. If section 263A requires the Specified Cooperative to include additional section 263A costs (as defined in §1.263A-1(d)(3)) in inventory, additional section 263A costs must be included in determining COGS. COGS also includes the Specified Cooperative's inventory valuation adjustments such as write-downs under the lower of cost or market method. In the case of a sale, exchange, or other disposition (including, for example, theft, casualty, or abandonment) by the Specified Cooperative of non-inventory property, COGS for purposes of this section includes the adjusted basis of the property.

(2) *Allocating COGS*—(i) *In general*. A Specified Cooperative must use a reasonable method based on all the facts and circumstances to allocate COGS between DPGR and non-DPGR. Whether an allocation method is reasonable is based on all the facts and circumstances, including whether the Specified Cooperative uses the most accurate information available; the relationship between COGS and the method used; the accuracy of the method chosen as compared with other possible methods; whether the method is used by the Specified Cooperative for internal management or other business purposes; whether the method is used for other Federal or state income tax purposes; the availability of costing information; the time, burden, and cost of using alternative methods; and whether the Specified Cooperative applies the method consistently from year to year. Depending on the facts and circumstances, reasonable methods may include methods based on gross receipts (defined in §1.199A-8(b)(2)(iii)), number of units sold, number of units produced, or total production costs. Ordinarily, if a Specified Cooperative uses a method to allocate gross receipts between DPGR and non-DPGR, then the use of a different method to allocate COGS that is not demonstrably more accurate than the method used to allocate gross receipts will not be considered reasonable. However, if a Specified Cooperative has information readily available to specifically identify COGS allocable to DPGR and can specifically identify that amount without undue burden or expense, COGS allocable to DPGR is that amount irrespective of whether the Specified Cooperative uses another allocation method to allocate gross receipts between DPGR and non-DPGR. A Specified Cooperative that does not have information readily available to specifically identify COGS allocable to DPGR and that cannot, without undue burden or expense, specifically identify that amount is not required to use a method that specifically identifies COGS allocable to DPGR. The chosen reasonable method must be consistently applied from one taxable year to another and must clearly reflect the portion of COGS between DPGR and non-DPGR. The method must also be reasonable based on all the facts and circumstances. The books and records maintained for COGS must be consistent with any allocations under this paragraph (b)(2).

(ii) *Gross receipts recognized in an earlier taxable year*. If the Specified Cooperative (other than a Specified Cooperative that uses the small business simplified overall method of paragraph (f) of this section) recognizes and reports gross receipts on a Federal income tax return for a taxable year, and incurs COGS related to such gross receipts in a subsequent taxable year, then regardless of whether the gross receipts ultimately qualify as DPGR, the Specified Cooperative must allocate the COGS to—

(A) DPGR if the Specified Cooperative identified the related gross receipts as DPGR in the prior taxable year; or

(B) Non-DPGR if the Specified Cooperative identified the related gross receipts as non-DPGR in the prior taxable year or if the Specified Cooperative recognized under the Specified Cooperative's methods of accounting those gross receipts in a taxable year to which section 199A(g) does not apply.

(iii) *COGS associated with activities undertaken in an earlier taxable year*—(A) *In general*. A Specified Cooperative must allocate its COGS between DPGR and non-DPGR under the rules provided in paragraphs (b)(2)(i) and (iii) of this section, regardless of whether certain costs included in its COGS can be associated with activities undertaken in an earlier taxable year (including a year prior to the effective date of section 199A(g)). A Specified Cooperative may not segregate its COGS into component costs and allocate those component costs between DPGR and non-DPGR.

(B) *Example*. The following example illustrates an application of paragraph (b)(2)(iii)(A) of this section.

(*1*) *Example*. During the 2018 taxable year, nonexempt Specified Cooperative X grew and sold Horticultural Product A. All of the patronage gross receipts from sales recognized by X in 2018 were from the sale of Horticultural Product A and qualified as DPGR. Employee 1 of X was involved in X's production process until he retired in 2013. In 2018, X paid $30 directly from its general assets for Employee 1's medical expenses pursuant to an unfunded, self-insured plan for retired X employees. For purposes of computing X's 2018 taxable income, X capitalized those medical costs to inventory under section 263A. In 2018, the COGS for a unit of Horticultural Product A was $100 (including the applicable portion of the $30 paid for Employee 1's medical costs that was allocated to COGS under X's allocation method for additional section 263A costs). X has information readily available to specifically identify COGS allocable to DPGR and can identify that amount without undue burden and expense because all of X's gross receipts from sales in 2018 are attributable to the sale of Horticultural Product A and qualify as DPGR. The inventory cost of each unit of Horticultural Product A sold in 2018, including the applicable portion of retiree medical costs, is related to X's gross receipts from the sale of Horticultural Product A in 2018. X may not segregate the 2018 COGS by separately allocating the retiree medical costs, which are components of COGS, to DPGR and non-DPGR. Thus, even though the retiree medical costs can be associated with activities undertaken in prior years, $100 of inventory cost of each unit of Horticultural Product A sold in 2018, including the applicable portion of the retiree medical expense cost component, is allocable to DPGR in 2018.

(3) *Special allocation rules*. Section 199A(g)(3)(C) provides the following two special rules—

(i) For purposes of determining the COGS that are allocable to DPGR, any item or service brought into the United States (defined in §1.199A-9(i)) is treated as acquired by purchase, and its cost is treated as not less than its value immediately after it entered the United States. A similar rule applies in determining the adjusted basis of leased or rented property where the lease or rental gives rise to DPGR.

(ii) In the case of any property described in paragraph (b)(3)(i) of this section that has been exported by the Specified Cooperative for further manufacture, the increase in cost or adjusted basis under paragraph (b)(3)(i) of this section cannot exceed the difference between the value of the property when exported and the value of the property when brought back into the United States after the further manufacture. For the purposes of this paragraph (b)(3), the value of property is its customs value as defined in section 1059A(b)(1).

(4) *Rules for inventories valued at market or bona fide selling prices*. If part of COGS is attributable to the Specified Cooperative's inventory valuation adjustments, then COGS allocable to DPGR includes inventory adjustments to agricultural or horticultural products that are MPGE in whole or significant part within the United States. Accordingly, a Specified Cooperative that values its inventory under §1.471-4 (inventories at cost or market, whichever is lower) or §1.471-2(c) (subnormal goods at bona fide selling prices) must allocate a proper share of such adjustments (for example, write-downs) to DPGR based on a reasonable method based on all the facts and circumstances. Factors taken into account in determining whether the method is reasonable include whether the Specified Cooperative uses the most accurate information available; the relationship between the adjustment and the allocation base chosen; the accuracy of the method chosen as compared with other possible methods; whether the method is used by the Specified Cooperative for internal management or other business purposes; whether the method is used for other Federal or state income tax purposes; the time, burden, and cost of using alternative methods; and whether the Specified Cooperative applies the method consistently from year to year. If the Specified Cooperative has information readily available to specifically identify the proper amount of inventory valuation adjustments allocable to DPGR, then the Specified Cooperative must allocate that amount to DPGR. The Specified Cooperative that does not have information readily available to specifically identify the proper amount of its inventory valuation adjustments allocable to DPGR and that cannot, without undue burden or expense, specifically identify the proper amount of its inventory valuation adjustments allocable to DPGR, is not required to use a method that specifically identifies inventory valuation adjustments to DPGR. The chosen reasonable method must be consistently applied from one taxable year to another and must clearly reflect inventory adjustments. The method must also be reasonable based on all the facts and circumstances. The books and records maintained for inventory adjustments must be consistent with any allocations under this paragraph (b)(4).

(5) *Rules applicable to inventories accounted for under the last-in, first-out inventory method*—(i) *In general*. This paragraph (b)(5) applies to inventories accounted for using the specific goods last-in, first-out (LIFO) method or the dollar-value LIFO method. Whenever a specific goods grouping or a dollar-value pool contains agricultural or horticultural products that produce DPGR and goods that do not, the Specified Cooperative must allocate COGS attributable to that grouping or pool between DPGR and non-DPGR using a reasonable method based on all the facts and circumstances. Whether a method of allocating COGS between DPGR and non-DPGR is reasonable must be determined in accordance with paragraph (b)(2) of this section. In addition, this paragraph (b)(5) provides methods that a Specified Cooperative may use to allocate COGS for a Specified Cooperative's inventories accounted for using the LIFO method. If the Specified Cooperative uses the LIFO/FIFO ratio method provided in paragraph (b)(5)(ii) of this section or the change in relative base-year cost method provided in paragraph (b)(5)(iii) of this section, then the Specified Cooperative must use that method for all of the Specified Cooperative's inventory accounted for under the LIFO method. The chosen reasonable method must be consistently applied from one taxable year to another and must clearly reflect the inventory method. The method must also be reasonable based on all the facts and circumstances. The books and records maintained for the inventory method must be

consistent with any allocations under this paragraph (b)(5).

(ii) *LIFO/FIFO ratio method*. The LIFO/FIFO ratio method is applied with respect to the LIFO inventory on a grouping-by-grouping or pool-by-pool basis. Under the LIFO/FIFO ratio method, a Specified Cooperative computes the COGS of a grouping or pool allocable to DPGR by multiplying the COGS of agricultural or horticultural products (defined in §1.199A-8(a)(4)) in the grouping or pool that produced DPGR computed using the FIFO method by the LIFO/FIFO ratio of the grouping or pool. The LIFO/FIFO ratio of a grouping or pool is equal to the total COGS of the grouping or pool computed using the LIFO method over the total COGS of the grouping or pool computed using the FIFO method.

(iii) *Change in relative base-year cost method*. A Specified Cooperative using the dollar-value LIFO method may use the change in relative base-year cost method. The change in relative base-year cost method for a Specified Cooperative using the dollar-value LIFO method is applied to all LIFO inventory on a pool-by-pool basis. The change in relative base-year cost method determines the COGS allocable to DPGR by increasing or decreasing the total production costs (section 471 costs and additional section 263A costs) of agricultural or horticultural products that generate DPGR by a portion of any increment or liquidation of the dollar-value pool. The portion of an increment or liquidation allocable to DPGR is determined by multiplying the LIFO value of the increment or liquidation (expressed as a positive number) by the ratio of the change in total base-year cost (expressed as a positive number) of agricultural or horticultural products that will generate DPGR in ending inventory to the change in total base-year cost (expressed as a positive number) of all goods in ending inventory. The portion of an increment or liquidation allocable to DPGR may be zero but cannot exceed the amount of the increment or liquidation. Thus, a ratio in excess of 1.0 must be treated as 1.0.

(6) *Specified Cooperative using a simplified method for additional section 263A costs to ending inventory*. A Specified Cooperative that uses a simplified method specifically described in the section 263A regulations to allocate additional section 263A costs to ending inventory must follow the rules in paragraph (b)(2) of this section to determine the amount of additional section 263A costs allocable to DPGR. Allocable additional section 263A costs include additional section 263A costs included in the Specified Cooperative's beginning inventory as well as additional section 263A costs incurred during the taxable year by the Specified Cooperative. Ordinarily, if the Specified Cooperative uses a simplified method specifically described in the section 263A regulations to allocate its additional section 263A costs to its ending inventory, the additional section 263A costs must be allocated in the same proportion as section 471 costs are allocated.

(c) *Other deductions properly allocable to DPGR or gross income attributable to DPGR*—(1) *In general*. In determining its QPAI, the Specified Cooperative must subtract from its DPGR (in addition to the COGS), the deductions that are properly allocable and apportioned to DPGR. A Specified Cooperative generally must allocate and apportion these deductions using the rules of the section 861 method provided in paragraph (d) of this section. In lieu of the section 861 method, an eligible Specified Cooperative may apportion these deductions using the simplified deduction method provided in paragraph (e) of this section. Paragraph (f) of this section provides a small business simplified overall method that may be used by a qualifying small Specified Cooperative. A Specified Cooperative using the simplified deduction method or the small business simplified overall method must use that method for all deductions. A Specified Cooperative eligible to use the small business simplified overall method may choose at any time for any taxable year to use the small business simplified overall method or the simplified deduction method for a taxable year.

(2) *Treatment of net operating losses*. A deduction under section 172 for a net operating loss (NOL) is not allocated or apportioned to DPGR or gross income attributable to DPGR.

(3) *W-2 wages*. Although only W-2 wages as described in §1.199A-11 are taken into account in computing the W-2 wage limitation, all wages paid (or incurred in the case of an accrual method taxpayer) in the taxable year are taken into account in computing QPAI for that taxable year.

(d) *Section 861 method*. Under the section 861 method, the Specified Cooperative must allocate and apportion its deductions using the allocation and apportionment rules provided under the section 861 regulations under which section 199A(g) is treated as an operative section described in §1.861-8(f). Accordingly, the Specified Cooperative applies the rules of the section 861 regulations to allocate and apportion deductions (including, if applicable, its distributive share of deductions from passthrough entities) to gross income attributable to DPGR. If the Specified Cooperative applies the allocation and apportionment rules of the section 861 regulations for section 199A(g) and another operative section, then the Specified Cooperative must use the same method of allocation and the same principles of apportionment for purposes of all operative sections. Research and experimental expenditures must be allocated and apportioned in accordance with §1.861-17 without taking into account the exclusive apportionment rule of §1.861-17(b). Deductions for charitable contributions (as allowed under section 170 and section 873(b)(2) or 882(c)(1)(B)) must be ratably apportioned between gross income attributable to DPGR and gross income attributable to non-DPGR based on the relative amounts of gross income.

(e) *Simplified deduction method*—(1) *In general*. An eligible Specified Cooperative (defined in paragraph (e)(2) of this section) may use the simplified deduction method to apportion business deductions between DPGR and non-DPGR. The simplified deduction method does not apply to COGS. Under the simplified deduction method, the business deductions (except the NOL deduction) are ratably apportioned between DPGR and non-DPGR based on relative gross receipts. Accordingly, the amount of deductions for the current taxable year apportioned to DPGR is equal to the proportion of the total business deductions for the current taxable year that the amount of DPGR bears to total gross receipts.

(2) *Eligible Specified Cooperative*. For purposes of this paragraph (e), an eligible Specified Cooperative is—

(i) A Specified Cooperative that has average annual total gross receipts (as defined in paragraph (g) of this section) of $100,000,000 or less; or

(ii) A Specified Cooperative that has total assets (as defined in paragraph (e)(3) of this section) of $10,000,000 or less.

(3) *Total assets*.—(i) *In general*. For purposes of the simplified deduction method, total assets mean the total assets the Specified Cooperative has at the end of the taxable year.

(ii) *Members of an expanded affiliated group*. To compute the total assets of an *expanded affiliated group* (EAG) at the end of the taxable year, the total assets at the end of the taxable year of each member of the EAG at the end of the taxable year that ends with or within the taxable year of the computing member (as described in §1.199A-12(g)) are aggregated.

(4) *Members of an expanded affiliated group*—(i) *In general*. Whether the members of an EAG may use the simplified deduction method is determined by reference to all the members of the EAG. If the average annual gross receipts of the EAG are less than or equal to $100,000,000 or the total assets of the EAG are less than or equal to $10,000,000, then each member of the EAG may individually determine whether to use the simplified deduction method, regardless of the cost allocation method used by the other members.

(ii) *Exception*. Notwithstanding paragraph (e)(4)(i) of this section, all members of the same consolidated group must use the same cost allocation method.

(f) *Small business simplified overall method*—(1) *In general*. A qualifying small Specified Cooperative may use the small business simplified overall method to apportion COGS and deductions between DPGR and non-DPGR. Under the small business simplified overall method, a Specified Cooperative's total costs for the current taxable year (as defined in paragraph (f)(3) of this section) are apportioned between DPGR and non-DPGR based on relative gross receipts. Accordingly, the amount of total costs for the current taxable year apportioned to DPGR is equal to the proportion of total costs for the current taxable year that the amount of DPGR bears to total gross receipts.

(2) *Qualifying small Specified Cooperative*. For purposes of this paragraph (f), a qualifying small Specified Cooperative is a Specified Cooperative that has average annual total gross receipts (as defined in paragraph (g) of this section) of $25,000,000 or less.

(3) *Total costs for the current taxable year*. For purposes of the small business simplified overall method, total costs for the current taxable year means the total COGS and deductions for the current taxable year. Total costs for the current taxable year are determined under the methods of accounting that the Specified Cooperative uses to compute taxable income.

(4) *Members of an expanded affiliated group*—(i) *In general*. Whether the members of an EAG may use the small business simplified overall method is determined by reference to all the members of the EAG. If the average annual gross receipts of the EAG are less than or equal to $25,000,000 then each member of the EAG may individually determine whether to use the small business simplified overall method, regardless of the cost allocation method used by the other members.

(ii) *Exception*. Notwithstanding paragraph (f)(4)(i) of this section, all members of the same consolidated group must use the same cost allocation method.

(g) *Average annual gross receipts*—(1) *In general*. For purposes of the simplified deduction method and the small business simplified overall method, average annual gross receipts means the average annual gross receipts of the Specified Cooperative for the 3 taxable years (or, if fewer, the taxable years during which the taxpayer was in existence) preceding the current taxable year, even if one or more of such taxable years began before the effective date of section 199A(g). In the case of any taxable year of less than 12 months (a short taxable year), the gross receipts of the Specified Cooperative are annualized by multiplying the gross receipts for the short period by 12 and dividing the result by the number of months in the short period.

(2) *Members of an expanded affiliated group*—(i) *In general*. To compute the average annual gross receipts of an EAG, the gross receipts for the entire taxable year of each member that is a member of the EAG at the end of its taxable year that ends with or within the taxable year are aggregated. For purposes of this paragraph (g)(2), a consolidated group is treated as one member of an EAG.

(ii) *Exception*. Notwithstanding paragraph (g)(1)(i) of this section, all members of the same consolidated group must use the same cost allocation method.

(h) *Cost allocation methods for determining oil-related QPAI*—(1) *Section 861 method*. A Specified Cooperative that uses the section 861 method to determine deductions that are allocated and apportioned to gross income attributable to DPGR must use the section 861 method to determine deductions that are allocated and apportioned to gross income attributable to oil-related DPGR.

(2) *Simplified deduction method*. A Specified Cooperative that uses the simplified deduction method to apportion deductions between DPGR and non-DPGR must determine the portion of deductions allocable to oil-related DPGR by multiplying the deductions allocable to DPGR by the ratio of oil-related DPGR to DPGR from all activities.

(3) *Small business simplified overall method*. A Specified Cooperative that uses the small business simplified overall method to apportion total costs (COGS and deductions) between DPGR and non-DPGR must determine the portion of total costs allocable to oil-related DPGR by multiplying the total costs allocable to DPGR by the ratio of oil-related DPGR to DPGR from all activities.

(i) *Applicability date*. The provisions of this section apply to taxable years ending after the date the Treasury decision adopting these regulations as final regulations is published in the *Federal Register*. Taxpayers, however, may rely on these regulations until that date, but only if the taxpayers apply the rules in their entirety and in a consistent manner.

§1.199A-11 Wage limitation for the section 199A(g) deduction.

(a) *Rules of application*—(1) *In general*. The provisions of this section apply solely for purposes of section 199A(g) of the Internal Revenue Code (Code). The provisions of this section provide guidance on determining the W-2 wage limitation as defined in §1.199A-8(b)(5)(ii)(B). Except as provided in paragraph (d)(2) of this section, the Form W-2, Wage and Tax Statement, or any subsequent form or document used in determining the amount of W-2 wages, are those issued for the calendar year ending during the taxable year of the Specified Cooperative (defined in §1.199A-8(a)(2)) for wages paid to employees (or former employees) of the Specified Cooperative for employment by the Specified Cooperative. Employees are limited to employees defined in section 3121(d)(1) and (2) (that is, officers of a corporate taxpayer and employees of the taxpayer under the common law rules). See paragraph (a)(5) of this section for the requirement that W-2 wages must have been included in a return filed with the Social Security Administration (SSA) within 60 days after the due date (including extensions) of the return. *See also* section 199A(a)(4)(C).

(2) *Wage limitation for section 199A(g) deduction*. The amount of the deduction allowable under section 199A(g) to the Specified Cooperative for any taxable year cannot exceed 50 percent of the W-2 wages (as defined in section 199A(g)(1)(B)(ii) and paragraph (b) of this section) for the taxable year that are attributable to domestic production gross receipts (DPGR), defined in §1.199A-8(b)(3)(ii), of agricultural or horticultural products defined in §1.199A-8(a)(4).

(3) *Wages paid by entity other than common law employer*. In determining W-2 wages, the Specified Cooperative may take into account any W-2 wages paid by another entity and reported by the other entity on Forms W-2 with the other entity as the employer listed in Box c of the Forms W-2, provided that the W-2 wages were paid to common law employees or officers of the Specified Cooperative for employment by the Specified Cooperative. In such cases, the entity paying the W-2 wages and reporting the W-2 wages on Forms W-2 is precluded from taking into account such wages for purposes of determining W-2 wages with respect to that entity. For purposes of this paragraph (a)(4), entities that pay and report W-2 wages on behalf of or with respect to other taxpayers can include, but are not limited to, certified professional employer organizations under section 7705, statutory employers under section 3401(d)(1), and agents under section 3504.

(4) *Requirement that wages must be reported on return filed with the Social Security Administration*—(i) *In general*. Pursuant to section 199A(g)(1)(B)(ii) and section 199A(b)(4)(C), the term W-2 wages does not include any amount that is not properly included in a return filed with SSA on or before the 60th day after the due date (including extensions) for such return. Under §31.6051-2 of this chapter, each Form W-2 and the transmittal Form W-3, Transmittal of Wage and Tax Statements, together constitute an information return to be filed with SSA. Similarly, each Form W-2c, Corrected Wage and Tax Statement, and the transmittal Form W-3 or W-3c, Transmittal of Corrected Wage and Tax Statements, together constitute an information return to be filed with SSA. In determining whether any amount has been properly included in a return filed with SSA on or before the 60th day after the due date (including extensions) for such return, each Form W-2 together with its accompanying Form W-3 is considered a separate information return and each Form W-2c together with its accompanying Form W-3 or Form W-3c is considered a separate information return. Section 6071(c) provides that Forms W-2 and W-3 must be filed on or before January 31 of the year following the calendar year to which such returns relate (but see the special rule in §31.6071(a)-1T(a)(3)(1) of this chapter for monthly returns filed under §31.6011(a)-5(a) of this chapter). Corrected Forms W-2 are required to be filed with SSA on or before January 31 of the year following the year in which the correction is made.

(ii) *Corrected return filed to correct a return that was filed within 60 days of the due date*. If a corrected information return (Return B) is filed with SSA on or before the 60th day after the due date (including extensions) of Return B to correct an information return (Return A) that was filed with SSA on or before the 60th day after the due date (including extensions) of the information return (Return A) and paragraph (a)(5)(iii) of this section does not apply, then the wage information on Return B must be included in determining W-2 wages. If a corrected information return (Return D) is filed with SSA later than the 60th day after the due date (including extensions) of Return D to correct an information return (Return C) that was filed with SSA on or before the 60th day after the due date (including extensions) of the information return (Return C), then if Return D reports an increase (or increases) in wages included in determining W-2 wages from the wage amounts reported on Return C, such increase (or increases) on Return D is disregarded in determining W-2 wages (and only the wage amounts on Return C may be included in determining W-2 wages). If Return D reports a decrease (or decreases) in wages included in determining W-2 wages from the amounts reported on Return C, then, in determining W-2 wages, the wages reported on Return C must be reduced by the decrease (or decreases) reflected on Return D.

(iii) *Corrected return filed to correct a return that was filed later than 60 days after the due date*. If an information return (Return F) is filed to correct an information return (Return E) that was not filed with SSA on or before the 60th day after the due date (including extensions) of Return E, then Return F (and any subsequent information returns filed with respect to Return E) will not be considered filed on or before the 60th day after the due date (including extensions) of Return F (or the subsequent corrected information return). Thus, if a Form W-2c is filed to correct a Form W-2 that was not filed with SSA on or before the 60th day after the due date (including extensions) of the Form W-2 (or to correct a Form W-2c relating to a Form W-2 that had not been filed with SSA on or before the 60th day after the due date (including extensions) of the Form W-2), then this Form W-2c is not to be considered to have been filed with SSA on or before the 60th day after the due date (including extensions) for this Form W-2c, regardless of when the Form W-2c is filed.

(b) *Definition of W-2 wages*—(1) *In general*. Section 199A(g)(1)(B)(ii) provides that the W-2 wages of the Specified Cooperative must be determined in the same manner as under section 199A(b)(4) (without regard to section 199A(b)(4)(B) and after application of section 199A(b)(5)). Section 199A(b)(4)(A) provides that the term W-2 wages means with respect to any person for any taxable year of such person, the amounts described in paragraphs (3) and (8) of section 6051(a) paid by such person with respect to employment of employees by such person during the calendar year ending during such taxable year. Thus, the term W-2 wages includes the total amount of wages as defined in section 3401(a); the total amount of elective deferrals (within the meaning of section 402(g)(3)); the compensation deferred under section 457; and the amount of designated Roth contributions (as defined in section 402A).

(2) *Section 199A(g) deduction*. Pursuant to section 199A(g)(3)(A), W-2 wages do not include any amount which is not properly allocable to DPGR for purposes of calculating qualified production activities income (QPAI) as defined in §1.199A-8(b)(4)(ii). The Specified Cooperative may determine the amount of wages that is properly allocable to DPGR using a reasonable method based on all the facts and circumstances. The chosen reasonable method must be consistently applied from one taxable year to another and must clearly reflect the wages allocable to DPGR for purposes of QPAI. The books and records maintained for wages allocable to DPGR for purposes of QPAI must be consistent with any allocations under this paragraph (b)(2).

(c) *Methods for calculating W-2 wages*. The Secretary may provide for methods to be used in calculating W-2 wages, including W-2 wages for short taxable years by publication in the Internal Revenue Bulletin (*see* §601.601(d)(2)(ii)(b) of this chapter).

(d) *Wage limitation — acquisitions, dispositions, and short taxable years*—(1) *In general*. For purposes of computing the deduction under section 199A(g) of the Specified Cooperative, in the case of an acquisition or disposition (as defined in section 199A(b)(5) and paragraph (d)(3) of this section) that causes more than one Specified Cooperative to be an employer of the employees of the acquired or disposed of Specified Cooperative during the calendar year, the W-2 wages of the Specified Cooperative for the calendar year of the acquisition or disposition are allocated between or among each Specified Cooperative based on the period during which the employees of the acquired or disposed of Specified Cooperatives were employed by the Specified Cooperative, regardless of which permissible method is used for reporting predecessor and successor wages on Form W-2, Wage and Tax Statement.

(2) *Short taxable year that does not include December 31*. If the Specified Cooperative has a short taxable year that does not contain a calendar year ending during such short taxable year, wages paid to employees for employment by the Specified Cooperative during the short taxable year are treated as W-2 wages for such short taxable year for purposes of paragraph (a) of this section (if the wages would otherwise meet the requirements to be W-2 wages under this section but for the requirement that a calendar year must end during the short taxable year).

(3) *Acquisition or disposition*. For purposes of paragraph (d)(1) and (2) of this section, the terms *acquisition* and *disposition* include an incorporation, a liquidation, a reorganization, or a purchase or sale of assets.

(e) *Application in the case of a Specified Cooperative with a short taxable year*. In the case of a Specified Cooperative with a short taxable year, subject to the rules of paragraph (a) of this section, the W-2 wages of the Specified Cooperative for the short taxable year can include only those wages paid during the short taxable year to employees of the Specified Cooperative, only those elective deferrals (within the meaning of section 402(g)(3)) made during the short taxable year by employees of the Specified Cooperative, and only compensation actually deferred under section 457 during the short taxable year with respect to employees of the Specified Cooperative.

(f) *Non-duplication rule*. Amounts that are treated as W-2 wages for a taxable year under any method cannot be treated as W-2 wages of any other taxable year. Also, an amount cannot be treated as W-2 wages by more than one taxpayer. Finally, an amount cannot be treated as W-2 wages by the Specified Cooperative both in determining patronage and nonpatronage W-2 wages.

(g) *Wage expense safe harbor*—(1) *In general*. A Specified Cooperative using either the section 861 method of cost allocation under §1.199A-10(d) or the simplified deduction method under §1.199A-10(e) may determine the amount of W-2 wages that are properly allocable to DPGR for a taxable year by multiplying the amount of W-2 wages determined under paragraph (b)(1) of this section for the taxable year by the ratio of the Specified Cooperative's wage expense included in calculating QPAI for the taxable year to the Specified Cooperative's total wage expense used in calculating the Specified Cooperative's taxable income for the taxable year, without regard to any wage expense disallowed by section 465, 469, 704(d), or 1366(d). A Specified Cooperative that uses either the section 861 method of cost allocation or the simplified deduction method to determine QPAI must use the same expense allocation and apportionment methods that it uses to determine QPAI to allocate and apportion wage expense for purposes of this safe harbor. For purposes of this paragraph (g)(1), the term wage expense means wages (that is, compensation paid by the employer in the active conduct of a trade or business to its employees) that are properly taken into account under the Specified Cooperative's method of accounting.

(2) *Wage expense included in cost of goods sold*. For purposes of paragraph (g)(1) of this section, a Specified Cooperative may determine its wage expense included in cost of goods sold (COGS) using a reasonable method based on all the facts and circumstances, such as using the amount of direct labor included in COGS or using section 263A labor costs (as defined in §1.263A-1(h)(4)(ii)) included in COGS. The chosen reasonable method must be consistently applied from one taxable year to another and must clearly reflect the portion of wage expense included in COGS. The method must also be reasonable based on all the facts and circumstances. The books and records maintained for wage expense included in COGS must be consistent with any allocations under this paragraph (g)(2).

(3) *Small business simplified overall method safe harbor*. The Specified Cooperative that uses the small business simplified overall method under §1.199A-10(f) may use the small business simplified overall method safe harbor for determining the amount of W-2 wages determined under paragraph (b)(1) of this section that is properly allocable to DPGR. Under this

safe harbor, the amount of W-2 wages determined under paragraph (b)(1) of this section that is properly allocable to DPGR is equal to the same proportion of W-2 wages determined under paragraph (b)(1) of this section that the amount of DPGR bears to the Specified Cooperative's total gross receipts.

(h) *Applicability date*. The provisions of this section apply to taxable years ending after the date the Treasury decision adopting these regulations as final regulations is published in the *Federal Register*. Taxpayers, however, may rely on these regulations until that date, but only if the taxpayers apply the rules in their entirety and in a consistent manner.

§1.199A-12 Expanded affiliated groups.

(a) *In general*. The provisions of this section apply solely for purposes of section 199A(g) of the Internal Revenue Code (Code). Except as otherwise provided in the Code or regulations issued under the relevant section of the Code (for example, sections 199A(g)(3)(D)(ii) and 267, §1.199A-8(c), paragraph (a)(3) of this section, and the consolidated return regulations under section 1502, each Specified Cooperative whether exempt or nonexempt (as defined in §1.199A-8(a)(2)(iii)) that is a member of an expanded affiliated group (EAG) (defined in paragraph (a)(1) of this section) computes its own taxable income or loss, qualified production activities income (QPAI) (defined in §1.199A-8(b)(4)(ii)), and W-2 wages (defined in §1.199A-11(b)). If a Specified Cooperative is also a member of a consolidated group, see paragraph (d) of this section.

(1) *Definition of an expanded affiliated group*. An EAG is an affiliated group as defined in section 1504(a), determined by substituting "more than 50 percent" for "at least 80 percent" in each place it appears and without regard to section 1504(b)(2) and (4).

(2) *Identification of members of an expanded affiliated group*—(i) *In general*. Each Specified Cooperative must determine if it is a member of an EAG on a daily basis.

(ii) *Becoming or ceasing to be a member of an expanded affiliated group*. If a Specified Cooperative becomes or ceases to be a member of an EAG, the Specified Cooperative is treated as becoming or ceasing to be a member of the EAG at the end of the day on which its status as a member changes.

(3) *Attribution of activities*—(i) *In general*. Except as provided in paragraph (a)(3)(iv) of this section, if a Specified Cooperative that is a member of an EAG (disposing member) derives gross receipts (defined in §1.199A-8(b)(2)(iii)) from the lease, rental, license, sale, exchange, or other disposition (defined in §1.199A-9(j)) of agricultural or horticultural products (defined in §1.199A-8(a)(4)) that were manufactured, produced, grown or extracted (MPGE) (as defined in §1.199A-9(f)), in whole or significant part (as defined in §1.199A-9(h)) in the United States (as defined in §1.199A-9(i)) by another Specified Cooperative, then the disposing member is treated as conducting the previous activities conducted by such other Specified Cooperative with respect to the agricultural or horticultural products in determining whether its gross receipts are domestic production gross receipts (DPGR) (defined in §1.199A-8(b)(3)(ii)) if—

(A) Such property was MPGE by such other Specified Cooperative, and

(B) The disposing member is a member of the same EAG as such other Specified Cooperative at the time that the disposing member disposes of the agricultural or horticultural products.

(ii) *Date of disposition for leases, rentals, or licenses*. Except as provided in paragraph (a)(3)(iv) of this section, with respect to a lease, rental, or license, the disposing member described in paragraph (a)(3)(i) of this section is treated as having disposed of the agricultural or horticultural products on the date or dates on which it takes into account the gross receipts derived from the lease, rental, or license under its methods of accounting.

(iii) *Date of disposition for sales, exchanges, or other dispositions*. Except as provided in paragraph (a)(3)(iv) of this section, with respect to a sale, exchange, or other disposition, the disposing member is treated as having disposed of the agricultural or horticultural products on the date on which it ceases to own the agricultural or horticultural products for Federal income tax purposes, even if no gain or loss is taken into account.

(iv) *Exception. Nonexempt Specified Cooperatives*. A nonexempt Specified Cooperative is not attributed nonpatronage activities conducted by another Specified Cooperative. *See* §1.199A-8(b)(2)(ii).

(4) *Marketing Specified Cooperatives*. A Specified Cooperative will be treated as having MPGE in whole or significant part any agricultural or horticultural product within the United States marketed by the Specified Cooperative which its patrons have so MPGE. Patrons are defined in §1.1388-1(e).

(5) *Anti-avoidance rule*. If a transaction between members of an EAG is engaged in or structured with a principal purpose of qualifying for, or increasing the amount of, the section 199A(g) deduction of the EAG or the portion of the section 199A(g) deduction allocated to one or more members of the EAG, the Secretary may make adjustments to eliminate the effect of the transaction on the computation of the section 199A(g) deduction.

(b) *Computation of EAG's section 199A(g) deduction*.—(1) *In general*. The section 199A(g) deduction for an EAG is determined by separately computing the section 199A(g) deduction from the patronage sources of Specified Cooperatives that are members of the EAG and the section 199A(g) deduction from the nonpatronage sources of exempt Specified Cooperatives that are members of the EAG. The section 199A(g) deduction from patronage sources of Specified Cooperatives is determined by aggregating the income or loss, QPAI, and W-2 wages, if any, of each patronage source of a Specified Cooperative that is a member of the EAG (whether an exempt or nonexempt Specified Cooperative). The section 199A(g) deduction from nonpatronage sources of exempt Specified Cooperatives is determined by aggregating the income or loss, QPAI, and W-2 wages, if any, of each nonpatronage source of exempt Specified Cooperatives that are members of the EAG. For purposes of this determination, a member's QPAI may be positive or negative. A Specified Cooperative's taxable income or loss and QPAI will be determined by reference to the Specified Cooperative's method of accounting. For purposes of determining the section 199A(g) deduction for an EAG, taxable income or loss, QPAI, and W-2 wages of a nonexempt Specified Cooperative from nonpatronage sources are considered to be zero. *See* §1.199A-8(b)(2)(ii).

(2) *Example*. The following examples illustrates the application of paragraph (b)(1) of this section.

(i) *Example*. Nonexempt Specified Cooperatives X, Y, and Z, calendar year taxpayers, are the only members of an EAG and are not members of a consolidated group. X's patronage source has taxable income of $50,000, QPAI of $15,000, and W-2 wages of $0. Y has patronage source taxable income of ($20,000), QPAI of ($1,000), and W-2 wages of $750. Z's patronage source has taxable income of $0, QPAI of $0, and W-2 wages of $3,000. In determining the EAG's section 199A(g) deduction, the EAG aggregates each member's patronage source's taxable income or loss, QPAI, and W-2 wages. Thus, the EAG's patronage source has taxable income of $30,000, the sum of X's patronage source taxable income of $50,000, Y's patronage source taxable income of ($20,000), and Z's patronage source taxable income of $0. The EAG has QPAI of $14,000, the sum of X's QPAI of $15,000, Y's QPAI of ($1,000), and Z's QPAI of $0. The EAG has W-2 wages of $3,750, the sum of X's W-2 wages of $0, Y's W-2 wages of $750, and Z's W-2 wages of $3,000. Accordingly, the EAG's section 199A(g) deduction equals $1,260, 9% of $14,000, the lesser of the QPAI and patronage source taxable income, but not greater than $1,875, 50% of its W-2 wages of $3,750. This result would be the same if X had a nonpatronage source income or loss, because nonpatronage source income of a nonexempt Specified Cooperative is not taken into account in determining the section 199A(g) deduction.

(3) *Net operating loss carryovers/carrybacks*. In determining the taxable income of an EAG, if a Specified Cooperative has a net operating loss (NOL) from its patronage sources that may be carried over or carried back, if applicable, (in accordance with section 172), to the taxable year, then for purposes of determining the taxable income of the Specified Cooperative, the amount of the NOL used to offset taxable income cannot exceed the taxable income of the patronage source of that Specified Cooperative. Similarly, if a Specified Cooperative has an NOL from its nonpatronage sources that may be carried over to the taxable year, then for purposes of determining the taxable income of the Specified Cooperative, the amount of the NOL used to offset taxable income cannot exceed the taxable income of the nonpatronage sources of that Specified Cooperative.

(4) *Losses used to reduce taxable income of an expanded affiliated group*. The amount of an NOL sustained by a Specified Cooperative member of an EAG that is used in the year sustained in determining an EAG's taxable income limitation under §1.199A-8(b)(5)(ii)(C) (for nonexempt Specified Cooperatives) or §1.199A-8(c)(4)(i) (for exempt Specified Cooperatives), as applicable, is not treated as an NOL carryover to any taxable year in determining the taxable income limitation under §1.199A-8(b)(5)(ii)(C) or §1.199A-8(c)(4)(i), as applicable. For purposes of this paragraph (b)(4), an NOL is considered to be used if it reduces an EAG's aggregate taxable income from patronage source or nonpatronage source, as the case may be, regardless of whether the use of the NOL actually reduces the amount of the section 199A(g) deduction that the EAG would otherwise derive. An NOL is not considered to be used to the extent that it reduces an EAG's aggregate taxable income from patronage source or nonpatronage source, as the case may be, to an amount less than zero. If more than one Specified Cooperative has an NOL used in the same taxable year to reduce the EAG's taxable income from patronage or nonpatronage sources, as the case may be, the respective NOLs are deemed used in proportion to the amount of each Specified Cooperative's NOL.

(5) *Example*. The following example illustrates the application of paragraph (b)(4) of this section.

(i) *Example*—(*A*) *Facts*. Nonexempt Specified Cooperatives A and B are the only two members of an EAG. A and B are both calendar year taxpayers and they do not join in the filing of a consolidated Federal income tax return. Neither A nor B had taxable income or loss prior to 2018. In 2018, A has patronage QPAI and taxable income of $1,000 and B has patronage QPAI of $1,000 and a patronage NOL of $1,500. A also has nonpatronage income of $3,000. B has no activities other than from its patronage activities. In 2019, A has patronage QPAI of $2,000 and patronage taxable income of $1,000 and B has patronage QPAI of $2,000 and patronage taxable income prior to the NOL deduction allowed under section 172 of $2,000. Neither A nor B has nonpatronage activities in 2019. A's and B's patronage activities have aggregate W-2 wages in excess of the section 199A(g)(1)(B) wage limitation in both 2018 and 2019.

(*B*) *Section 199A(g) deduction for 2018*. In determining the EAG's section 199A(g) deduction for 2018, A's $1,000 of QPAI and B's $1,000 of QPAI are aggregated, as are A's $1,000 of taxable income from its patronage activities and B's $1,500 NOL from its patronage activities. A's nonpatronage income is not included. Thus, for 2018, the EAG has patronage QPAI of $2,000 and patronage taxable income of ($500). The EAG's section 199A(g) deduction for 2018 is 9% of the lesser of its patronage QPAI or its patronage taxable income. Because the EAG has a taxable loss from patronage sources in 2018, the EAG's section 199A(g) deduction is $0.

(*C*) *Section 199A(a) deduction for 2019*. In determining the EAG's section 199A deduction for 2019, A's patronage QPAI of $2,000 and B's patronage QPAI of $2,000 are aggregated, resulting in the EAG having patronage QPAI of $4,000. Also, $1,000 of B's patronage NOL from 2018 was used in 2018 to reduce the EAG's taxable income from patronage sources to $0. The remaining $500 of B's patronage NOL from 2018 is not considered to have been used in 2018 because it reduced the EAG's patronage taxable income to less than $0. Accordingly, for purposes of determining the EAG's taxable income limitation under §1.199A-8(b)(5) in 2019, B is deemed to have only a $500 NOL carryover from its patronage sources from 2018 to offset a portion of its 2019 taxable income from its patronage sources. Thus, B's taxable income from its patronage sources in 2019 is $1,500, which is aggregated with A's $1,000 of taxable income from its patronage sources. The EAG's taxable income limitation in 2019 is $2,500. The EAG's section 199A(g) deduction is 9% of the lesser of its patronage sourced QPAI of $4,000 and its taxable income from patronage sources of $2,500. Thus, the EAG's section 199A(g) deduction in 2019 is 9% of $2,500, or $225. The results for 2019 would be the same if neither A nor B had patronage sourced QPAI in 2018.

(c) *Allocation of an expanded affiliated group's section 199A(g) deduction among members of the expanded affiliated group*—(1) *In general*. An EAG's section 199A(g) deduction from its patronage sources, as determined in paragraph (b) of this section, is allocated among the Specified Cooperatives that are members of the EAG in proportion to each Specified Cooperative's patronage QPAI, regardless of whether the Specified Cooperative has patronage taxable income or W-2 wages for the taxable year. An EAG's section 199A(g) deduction from its nonpatronage sources, as determined in paragraph (b) of this section, is allocated among the Specified Cooperatives that are members of the EAG in proportion to each Specified Cooperative's nonpatronage QPAI, regardless of whether the Specified Cooperative has nonpatronage taxable income or W-2 wages for the taxable year. For these purposes, if a Specified Cooperative has negative patronage or nonpatronage QPAI, such QPAI is treated as zero. Pursuant to §1.199A-8(b)(6), a patronage section 199A(g) deduction can be applied only against patronage income and deductions. Pursuant to §1.199A-8(c)(ii), a nonpatronage section 199A(g) deduction and can be applied only against nonpatronage income and deductions.

(2) *Use of section 199A(g) deduction to create or increase a net operating loss*. If a Specified Cooperative that is a member of an EAG has some or all of the EAG's section 199A(g) deduction allocated to it under paragraph (c)(1) of this section and the amount allocated exceeds patronage or nonpatronage taxable income, determined as described in this section and prior to allocation of the section 199A(g) deduction, the section 199A(g) deduction will create an NOL for the patronage source or nonpatronage source. Similarly, if a Specified Cooperative that is a member of an EAG, prior to the allocation of some or all of the EAG's section 199A(g) deduction to the member, has a patronage or nonpatronage NOL for the taxable year, the portion of the EAG's section 199A(g) deduction allocated to the member will increase such NOL.

(d) *Special rules for members of the same consolidated group*—(1) *Intercompany transactions*. In the case of an intercompany transaction between consolidated group members S and B (as the terms intercompany transaction, S and B are defined in §1.1502-13(b)(1)), S takes the intercompany transaction into account in computing the section 199A(g) deduction at the same time and in the same proportion as S takes into account the income, gain, deduction, or loss from the intercompany transaction under §1.1502-13.

(2) *Application of the simplified deduction method and the small business simplified overall method*. For purposes of applying the simplified deduction method under §1.199A-10(e) and the small business simplified overall method under §1.199A-10(f), a Specified Cooperative that is part of a consolidated group determines its QPAI using its members' DPGR, non-DPGR, cost of goods sold (COGS), and all other deductions, expenses, or losses (hereinafter deductions), determined after application of §1.1502-13.

(3) *Determining the section 199A(g) deduction*—(i) *Expanded affiliated group consists of consolidated group and non-consolidated group members*. In determining the section 199A(g) deduction, if an EAG includes Specified Cooperatives that are members of the same consolidated group and Specified Cooperatives that are not members of the same consolidated group, the consolidated taxable income or loss, QPAI, and W-2 wages, from patronage sources, if any, of the consolidated group (and not the separate taxable income or loss, QPAI, and W-2 wages from patronage sources of the members of the consolidated group), are aggregated with the taxable income or loss, QPAI, and W-2 wages, from patronage sources, if any, of the non-consolidated group members. A similar rule applies with respect to nonpatronage taxable income or loss, QPAI, and W-2 wages. For example, if A, B, C, S1, and S2 are Specified Cooperatives that are members of the same EAG, and A, S1, and S2 are members of the same consolidated group (the A consolidated group), then the A consolidated group is treated as one member of the EAG. Accordingly, the EAG is considered to have three members, the A consolidated group, B, and C. The consolidated taxable income or loss, QPAI, and W-2 wages from patronage sources, if any, of the A consolidated group are aggregated with the taxable income or loss from patronage sources, QPAI, and W-2 wages, if any, of B and C in determining the EAG's section 199A(g) deduction from patronage sources. Similarly, the consolidated taxable income or loss, QPAI, and W-2 wages from nonpatronage sources, if any, of the A consolidated group are aggregated with the taxable income or loss from nonpatronage sources, QPAI, and W-2 wages, if any, of B and C in determining the EAG's section 199A(g) deduction from nonpatronage sources. Pursuant to §1.199A-8(b)(6), a patronage section 199A(g) deduction can be applied only against patronage income and deductions. Pursuant to §1.199A-8(c)(ii), a nonpatronage section 199A(g) deduction and can be applied only against nonpatronage income and deductions.

(ii) *Expanded affiliated group consists only of members of a single consolidated group*. If all of the Specified Cooperatives that are members of an EAG are also members of the same consolidated group, the consolidated group's section 199A(g) deduction is determined using the consolidated group's consolidated taxable income or loss, QPAI, and W-2 wages, from patronage sources or nonpatronage sources, as the case may be, rather than the separate taxable income or loss, QPAI, and W-2 wages from patronage sources or nonpatronage sources of its members.

(4) *Allocation of the section 199A(g) deduction of a consolidated group among its members*. The section 199A(g) deduction from patronage sources of a consolidated group (or the section 199A(g) deduction allocated to a consolidated group that is a member of an EAG) is allocated among the patronage sources of Specified Cooperatives in proportion to each Specified Cooperative's patronage QPAI, regardless of whether the Specified Cooperative has patronage separate taxable income or W-2 wages for the taxable year. In allocating the section 199A(g) deduction of a patronage source of a Specified Cooperative that is part of a consolidated group among patronage sources of other members of the same group, any redetermination of a member's patronage receipts, COGS, or other deductions from an intercompany transaction under §1.1502-13(c)(1)(i) or (c)(4) is not taken into account for purposes of section 199A(g). Also, for purposes of this allocation, if a patronage source of a Specified Cooperative that is a member of a consolidated group has negative QPAI, the QPAI of the patronage source is treated as zero.

(e) *Examples*. The following examples illustrate the application of paragraphs (a) through (d) of this section.

(i) *Example 1*. Specified Cooperatives X, Y, and Z are members of the same EAG but are not members of a consolidated group. X, Y, and Z each files Federal income tax returns on a calendar year basis. None of X, Y, or Z have activities other than from its patronage sources. Prior to 2018, X had no taxable income or loss. In 2018, X has taxable income of $0, QPAI of $2,000, and W-2 wages of $0, Y has taxable income of $4,000, QPAI of $3,000, and W-2 wages of $500, and Z has taxable income of $4,000, QPAI of $5,000, and W-2 wages of $2,500. Accordingly, the EAG's patronage source taxable income is $8,000, the sum of X's taxable income of $0, Y's taxable income of $4,000, and Z's taxable income of $4,000. The EAG has QPAI of $10,000, the sum of X's QPAI of $2,000, Y's QPAI of $3,000, and Z's QPAI of $5,000. The EAG's W-2 wages are $3,000, the sum of X's W-2 wages of $0, Y's W-2 wages of $500, and Z's W-2 wages of $2,500. Thus, the EAG's section 199A(g) deduction for 2018 is $720 (9% of the lesser of the EAG's patronage source taxable income of $8,000 and the EAG's QPAI of $10,000, but no greater than 50% of its W-2 wages of $3,000, i.e., $1,500). Pursuant to paragraph (c)(1) of this section, the $720 section 199A(g) deduction is allocated to X, Y, and Z in proportion to their respective amounts of QPAI, that is $144 to X ($720 × $2,000/$10,000), $216 to Y ($720 × $3,000/$10,000), and $360 to Z ($720 × $5,000/$10,000). Although X's patronage source taxable income for 2018 determined prior to allocation of a portion of the EAG's section 199A(g) deduction to it was $0, pursuant to paragraph (c)(2) of this section, X will have an NOL from its patronage source for 2018 equal to $144, which will be a carryover to 2019.

(ii) *Example 2*. (A) *Facts*. Corporation X is the common parent of a consolidated group, consisting of X and Y, which has filed a consolidated Federal income tax return for many years. Corporation P is the common parent of a consolidated group, consisting of P and S, which has filed a consolidated Federal income tax return for many years. The X and P consolidated groups each file their consolidated Federal income tax returns on a calendar year basis. X, Y, P, and S are each Specified Cooperatives, and none of X, Y, P, or S has ever had activities other than from its patronage sources. The X consolidated group and the P consolidated group are members of the same EAG in 2019. In 2018, the X consolidated group incurred a consolidated net operating loss (CNOL) of $25,000. Neither P nor S (nor the P consolidated group) has ever incurred an NOL. In 2019, the X consolidated group has (prior to the deduction under section 172) taxable income of $8,000 and the P consolidated group has taxable income of $20,000. X's QPAI is $8,000, Y's QPAI is ($13,000), P's QPAI is $16,000 and S's QPAI is $4,000. There are sufficient W-2 wages to exceed the section 199A(g)(1)(B) limitation.

(B) *Analysis*. The X consolidated group uses $8,000 of its CNOL from 2018 to offset the X consolidated group's taxable income in 2019. None of the X consolidated group's remaining CNOL may be used to offset taxable income of the P consolidated group under paragraph (b)(3) of this section. Accordingly, for purposes of determining the EAG's section 199A(g) deduction for 2019, the EAG has taxable income of $20,000 (the X consolidated group's taxable income, after the deduction under section 172, of $0 plus the P consolidated group's taxable income of $20,000). The EAG has QPAI of $15,000 (the X consolidated group's QPAI of ($5,000) (X's $8,000 + Y's ($13,000)), and the P consolidated group's QPAI of $20,000 (P's $16,000 + S's $4,000)). The EAG's section 199A(g) deduction equals $1,350, 9% of the lesser of its taxable income of $20,000 and its QPAI of $15,000. The section 199A(g) deduction is allocated between the X and P consolidated groups in proportion to their respective QPAI. Because the X consolidated group has negative QPAI, all of the section 199A(g) deduction of $1,350 is allocated to the P consolidated group. This $1,350 is allocated between P and S, the members of the P consolidated group, in proportion to their QPAI. Accordingly, P is allocated $1,080 ($1,350 x ($16,000/$20,000) and S is allocated $270 ($1,350 x $4,000/$20,000)).

(f) *Allocation of patronage income and loss by a Specified Cooperative that is a member of the expanded affiliated group for only a portion of the year*—(1) *In general*. A Specified Cooperative that becomes or ceases to be a member of an EAG during its taxable year must allocate its taxable income or loss, QPAI, and W-2 wages between the portion of the taxable year that the Specified Cooperative is a member of the EAG and the portion of the taxable year that the Specified Cooperative is not a member of the EAG. This allocation of items is made by using the pro rata allocation method described in this paragraph (f)(1). Under the pro rata allocation method, an equal portion of patronage taxable income or loss, QPAI, and W-2 wages, and nonpatronage taxable income or loss, QPAI, and W-2 wages for the taxable year is assigned to each day of the Specified Cooperative's taxable year. Those items assigned to those days that the Specified Cooperative was a member of the EAG are then aggregated.

(2) *Coordination with rules relating to the allocation of income under §1.1502-76(b)*. If §1.1502-76(b) (relating to items included in a consolidated return) applies to a Specified Cooperative that is a member of an EAG, then any allocation of items required under this paragraph (f) is made only after the allocation of the items pursuant to §1.1502-76(b).

(g) *Total section 199A(g) deduction for a Specified Cooperative that is a member of an expanded affiliated group for some or all of its taxable year*—(1) *Member of the same EAG for the entire taxable year*. If a Specified Cooperative is a member of the same EAG for its entire taxable year, the Specified Cooperative's section 199A(g) deduction for the taxable year (whether patronage sourced or nonpatronage sourced) is the amount of the section 199A(g) deduction allocated to it by the EAG under paragraph (c)(1) of this section.

(2) *Member of the expanded affiliated group for a portion of the taxable year*. If a Specified Cooperative is a member of an EAG for only a portion of its taxable year and is either not a member of any EAG or is a member of another EAG, or both, for another portion of the taxable year, the Specified Cooperative's section 199A(g) deduction for the taxable year (whether patronage sourced or nonpatronage sourced) is the sum of its section 199A(g) deductions for each portion of the taxable year.

(3) *Example*. The following example illustrates the application of paragraphs (f) and (g) of this section.

(i) *Example*—(A) *Facts*. Specified Cooperatives X and Y, calendar year taxpayers, are members of the same EAG for the entire 2018 taxable year. Specified Cooperative Z, also a calendar year taxpayer, is a member of the EAG of which X and Y are members for the first half of 2018 and not a member of any EAG for the second half of 2018. Assume that X, Y, and Z each has W-2 wages in excess of the section 199A(g)(1)(B) wage limitation for all relevant periods. In 2018, X's patronage source has taxable income of $2,000 and QPAI of $600, Y's patronage source has a taxable loss of $400 and QPAI of ($200), and Z's patronage source has taxable income of $1,400 and QPAI of $2,400.

(B) *Analysis*. Pursuant to the pro rata allocation method, $700 of Z's 2018 patronage taxable income and $1,200 of its 2018 QPAI are allocated to the first half of the 2018 taxable year (the period in which Z is a member of the EAG) and $700 of Z's 2018 patronage taxable income and $1,200 of its 2018 QPAI are allocated to the second half of the 2018 taxable year (the period in which Z is not a member of any EAG). Accordingly, in 2018, the EAG has taxable income from patronage source of $2,300 (X's $2,000 + Y's ($400) + Z's $700) and QPAI of $1,600 (X's $600 + Y's ($200) + Z's $1,200). The EAG's section 199A(g) deduction for 2018 is $144 (9% of the lesser of the EAG's taxable income from patronage source of $2,300 or QPAI of $1,600). Pursuant to §1.199A-14(c)(1), this $144 deduction is allocated to X's, Y's, and Z's patronage source in proportion to their respective QPAI. Accordingly, X's patronage source is allocated $48 of the EAG's section 199A(g) deduction ($144 x ($600/($600 + $0 + $1,200))), Y's patronage source is allocated $0 of the EAG's section 199A(g) deduction ($144 x ($0 / ($600 + $0 + $1,200))), and Z's patronage source is allocated $96 of the EAG's section 199A(g) deduction ($144 x ($1,200 / ($600 + $0 + $1,200))). For the second half of 2018, Z's patronage source has taxable income of $700 and QPAI of $1,200. Therefore, for the second half of 2018, Z's patronage source has a section 199A(g) deduction of $63 (9% of the lesser of its taxable income of $700 or its QPAI of $1,200 for the second half of 2018). Accordingly, X's 2018 section 199A(g) deduction is $48 and Y's 2018 section 199A(g) deduction is $0. Z's 2018 section 199A(g) deduction is $159, the sum of the $96 section 199A(g) deduction of the EAG allocated to Z for the first half of 2018 and Z's $63 section 199A(g) deduction for the second half of 2018.

(h) *Computation of section 199A(g) deduction for members of an expanded affil-*

iated group with different taxable years—(1) *In general*. If Specified Cooperatives that are members of an EAG have different taxable years, in determining the section 199A(g) deduction of a member (the computing member), the computing member is required to take into account the taxable income or loss, determined without regard to the section 199A(g) deduction, QPAI, and W-2 wages of each other group member that are both—

(i) Attributable to the period that each other member of the EAG and the computing member are members of the EAG; and

(ii) Taken into account in a taxable year that begins after the effective date of section 199A(g) and ends with or within the taxable year of the computing member with respect to which the section 199A(g) deduction is computed.

(2) *Example*. The following example illustrates the application of this paragraph (h).

(i) *Example*. (A) Specified Cooperatives X, Y, and Z are members of the same EAG. Neither X, Y, nor Z is a member of a consolidated group. X and Y are calendar year taxpayers and Z is a June 30 fiscal year taxpayer. Z came into existence on July 1, 2017. All of X, Y's, and Z's activities are patronage sourced. Each Specified Cooperative has taxable income that exceeds its QPAI and W-2 wages in excess of the section 199A(g)(1)(B) wage limitation. For the taxable year ending December 31, 2018, X's QPAI is $8,000 and Y's QPAI is ($6,000). For its taxable year ending June 30, 2019, Z's QPAI is $2,000.

(B) In computing X's and Y's respective section 199A(g) deductions for their taxable years ending December 31, 2018, X's taxable income or loss, QPAI and W-2 wages and Y's taxable income or loss, QPAI, and W-2 wages from their respective taxable years ending December 31, 2018, are aggregated. The EAG's QPAI for this purpose is $2,000 (X's QPAI of $8,000 + Y's QPAI of ($6,000)). The $180 deduction is allocated to each of X and Y in proportion to their respective QPAI as a percentage of the QPAI of each member of the EAG that was taken into account in computing the EAG's section 199A(g) deduction. Pursuant to paragraph (c)(1) of this section, in allocating the section 199A(g) deduction between X and Y, because Y's QPAI is negative, Y's QPAI is treated as being $0. Accordingly, X's section 199A(g) deduction for its taxable year ending December 31, 2018, is $180 ($180 × $8,000/($8,000 + $0)). Y's section 199A(g) deduction for its taxable year ending December 31, 2018, is $0 ($180 × $0/($8,000 + $0)).

(C) In computing Z's section 199A(g) deduction for its taxable year ending June 30, 2019, X's and Y's items from their respective taxable years ending December 31, 2018, are taken into account. Therefore, X's taxable income or loss and Y's taxable income or loss, determined without regard to the section 199A(g) deduction, QPAI, and W-2 wages from their taxable years ending December 31, 2018, are aggregated with Z's taxable income or loss, QPAI, and W-2 wages from its taxable year ending June 30, 2019. The EAG's QPAI is $4,000 (X's QPAI of $8,000 + Y's QPAI of ($6,000) + Z's QPAI of $2,000). The EAG's section 199A(g) deduction is $360 (9% × $4,000). A portion of the $360 deduction is allocated to Z in proportion to its QPAI as a percentage of the QPAI of each member of the EAG that was taken into account in computing the EAG's section 199A(g) deduction. Pursuant to paragraph (c)(1) of this section, in allocating a portion of the $360 deduction to Z, Y's QPAI is treated as being $0 because Y's QPAI is negative. Z's section 199A(g) deduction for its taxable year ending June 30, 2019, is $72 ($360 × ($2,000/($8,000 + $0 + $2,000))).

(i) *Partnership owned by expanded affiliated group*—(1) *In general*. For purposes of section 199A(g)(3)(D) relating to DPGR, if all of the interests in the capital and profits of a partnership are owned by members of a single EAG at all times during the taxable year of such partnership (EAG partnership), then the EAG partnership and all members of that EAG are treated as a single taxpayer during such period.

(2) *Attribution of activities*—(*i*) *In general*. If a Specified Cooperative which is a member of an EAG (disposing member) derives gross receipts from the lease, rental, license, sale, exchange, or other disposition of property that was MPGE by an EAG partnership, all the partners of which are members of the same EAG to which the disposing member belongs at the time that the disposing member disposes of such property, then the disposing member is treated as conducting the MPGE activities previously conducted by the EAG partnership with respect to that property. The previous sentence applies only for those taxable years in which the disposing member is a member of the EAG of which all the partners of the EAG partnership are members for the entire taxable year of the EAG partnership. With respect to a lease, rental, or license, the disposing member is treated as having disposed of the property on the date or dates on which it takes into account its gross receipts from the lease, rental, or license under its method of accounting. With respect to a sale, exchange, or other disposition, the disposing member is treated as having disposed of the property on the date it ceases to own the property for Federal income tax purposes, even if no gain or loss is taken into account. Likewise, if an EAG partnership derives gross receipts from the lease, rental, license, sale, exchange, or other disposition of property that was MPGE by a member (or members) of the same EAG (the producing member) to which all the partners of the EAG partnership belong at the time that the EAG partnership disposes of such property, then the EAG partnership is treated as conducting the MPGE activities previously conducted by the producing member with respect to that property. The previous sentence applies only for those taxable years in which the producing member is a member of the EAG of which all the partners of the EAG partnership are members for the entire taxable year of the EAG partnership. With respect to a lease, rental, or license, the EAG partnership is treated as having disposed of the property on the date or dates on which it takes into account its gross receipts derived from the lease, rental, or license under its method of accounting. With respect to a sale, exchange, or other disposition, the EAG partnership is treated as having disposed of the property on the date it ceases to own the property for Federal income tax purposes, even if no gain or loss is taken into account.

(*ii*) *Attribution between expanded affiliated group partnerships*. If an EAG partnership (disposing partnership) derives gross receipts from the lease, rental, license, sale, exchange, or other disposition of property that was MPGE by another EAG partnership (producing partnership), then the disposing partnership is treated as conducting the MPGE activities previously conducted by the producing partnership with respect to that property, provided that each of these partnerships (the producing partnership and the disposing partnership) is owned for its entire taxable year in which the disposing partnership disposes of such property by members of the same EAG. With respect to a lease, rental, or license, the disposing partnership is treated as having disposed of the property on the date or dates on which it takes into account its gross receipts from the lease, rental, or license under its method of accounting. With respect to a sale, exchange, or other disposition, the disposing partnership is treated as having disposed of the property on the date it ceases to own the property for Federal income tax purposes, even if no gain or loss is taken into account.

(*iii*) *Exception*. No member of an EAG other than an exempt Specified Cooperative is attributed nonpatronage activities conducted by an EAG partnership. An EAG partnership is not attributed nonpatronage activities conducted by any member of the EAG or by another EAG partnership.

(j) *Applicability date*. The provisions of this section apply to taxable years ending after the date the Treasury decision adopting these regulations as final regulations is published in the *Federal Register*. Taxpayers, however, may rely on these regulations until that date, but only if the taxpayers apply the rules in their entirety and in a consistent manner.

Par. 3. Section 1.1388-1 is amended by adding paragraphs (f) and (g).

The additions read as follows:

§1.1388-1 Definitions and special rules.

* * * * *

(f) *Patronage and nonpatronage*. Whether an item of income or deduction is patronage or nonpatronage sourced is determined by applying the directly related use test. The directly related use test provides that if the income or deduction is produced by a transaction that actually facilitates the accomplishment of the cooperative's marketing, purchasing, or services activities, the income or deduction is from patronage sources. However, if the transaction producing the income or deduction does not actually facilitate the accomplishment of these activities but merely enhances the overall profitability of the cooperative, being merely incidental to the association's cooperative operation, the income or deduction is from nonpatronage sources. Patronage and nonpatronage income or deductions cannot be netted unless otherwise permitted by the Internal Revenue Code or regulations issued under the relevant section of the Internal Revenue Code, or guidance published in the Internal Revenue Bulletin (*see* §601.601(d)(2) of this chapter).

(g) *Effective/applicability date*. The provisions of paragraph (f) of this section apply to taxable years ending after the date the Treasury decision adopting these regulations as final regulations is published in the *Federal Register*. However, taxpayers may rely on the provisions of paragraph (f) of this section until the date the Treasury decision adopting these regulations as final regulations is published in the *Federal Register*.

Kirsten Wielobob,
Deputy Commissioner for Services and Enforcement.

(Filed by the Office of the Federal Register on June 18, 2019, 8:45 a.m., and published in the issue of the Federal Register for June 19, 2019, 84 F.R. 28668)

Definition of Terms

Revenue rulings and revenue procedures (hereinafter referred to as "rulings") that have an effect on previous rulings use the following defined terms to describe the effect:

Amplified describes a situation where no change is being made in a prior published position, but the prior position is being extended to apply to a variation of the fact situation set forth therein. Thus, if an earlier ruling held that a principle applied to A, and the new ruling holds that the same principle also applies to B, the earlier ruling is amplified. (Compare with *modified*, below).

Clarified is used in those instances where the language in a prior ruling is being made clear because the language has caused, or may cause, some confusion. It is not used where a position in a prior ruling is being changed.

Distinguished describes a situation where a ruling mentions a previously published ruling and points out an essential difference between them.

Modified is used where the substance of a previously published position is being changed. Thus, if a prior ruling held that a principle applied to A but not to B, and the new ruling holds that it applies to both A and B, the prior ruling is modified because it corrects a published position. (Compare with *amplified* and *clarified*, above).

Obsoleted describes a previously published ruling that is not considered determinative with respect to future transactions. This term is most commonly used in a ruling that lists previously published rulings that are obsoleted because of changes in laws or regulations. A ruling may also be obsoleted because the substance has been included in regulations subsequently adopted.

Revoked describes situations where the position in the previously published ruling is not correct and the correct position is being stated in a new ruling.

Superseded describes a situation where the new ruling does nothing more than restate the substance and situation of a previously published ruling (or rulings). Thus, the term is used to republish under the 1986 Code and regulations the same position published under the 1939 Code and regulations. The term is also used when it is desired to republish in a single ruling a series of situations, names, etc., that were previously published over a period of time in separate rulings. If the new ruling does more than restate the substance of a prior ruling, a combination of terms is used. For example, *modified* and *superseded* describes a situation where the substance of a previously published ruling is being changed in part and is continued without change in part and it is desired to restate the valid portion of the previously published ruling in a new ruling that is self contained. In this case, the previously published ruling is first modified and then, as modified, is superseded.

Supplemented is used in situations in which a list, such as a list of the names of countries, is published in a ruling and that list is expanded by adding further names in subsequent rulings. After the original ruling has been supplemented several times, a new ruling may be published that includes the list in the original ruling and the additions, and supersedes all prior rulings in the series.

Suspended is used in rare situations to show that the previous published rulings will not be applied pending some future action such as the issuance of new or amended regulations, the outcome of cases in litigation, or the outcome of a Service study.

Abbreviations

The following abbreviations in current use and formerly used will appear in material published in the Bulletin.

A—Individual.
Acq.—Acquiescence.
B—Individual.
BE—Beneficiary.
BK—Bank.
B.T.A.—Board of Tax Appeals.
C—Individual.
C.B.—Cumulative Bulletin.
CFR—Code of Federal Regulations.
CI—City.
COOP—Cooperative.
Ct.D.—Court Decision.
CY—County.
D—Decedent.
DC—Dummy Corporation.
DE—Donee.
Del. Order—Delegation Order.
DISC—Domestic International Sales Corporation.
DR—Donor.
E—Estate.
EE—Employee.
E.O.—Executive Order.
ER—Employer.
ERISA—Employee Retirement Income Security Act.
EX—Executor.
F—Fiduciary.
FC—Foreign Country.
FICA—Federal Insurance Contributions Act.
FISC—Foreign International Sales Company.
FPH—Foreign Personal Holding Company.
F.R.—Federal Register.
FUTA—Federal Unemployment Tax Act.
FX—Foreign corporation.
G.C.M.—Chief Counsel's Memorandum.
GE—Grantee.
GP—General Partner.
GR—Grantor.
IC—Insurance Company.
I.R.B.—Internal Revenue Bulletin.
LE—Lessee.
LP—Limited Partner.
LR—Lessor.
M—Minor.
Nonacq.—Nonacquiescence.
O—Organization.
P—Parent Corporation.
PHC—Personal Holding Company.
PO—Possession of the U.S.
PR—Partner.
PRS—Partnership.
PTE—Prohibited Transaction Exemption.
Pub. L.—Public Law.
REIT—Real Estate Investment Trust.
Rev. Proc.—Revenue Procedure.
Rev. Rul.—Revenue Ruling.
S—Subsidiary.
S.P.R.—Statement of Procedural Rules.
Stat.—Statutes at Large.
T—Target Corporation.
T.C.—Tax Court.
T.D.—Treasury Decision.
TFE—Transferee.
TFR—Transferor.
T.I.R.—Technical Information Release.
TP—Taxpayer.
TR—Trust.
TT—Trustee.
U.S.C.—United States Code.
X—Corporation.
Y—Corporation.
Z—Corporation.

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[1] A cumulative list of all revenue rulings, revenue procedures, Treasury decisions, etc., published in Internal Revenue Bulletins 2018–27 through 2018–52 is in Internal Revenue Bulletin 2018–52, dated December 27, 2018.

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[1] A cumulative list of all revenue rulings, revenue procedures, Treasury decisions, etc., published in Internal Revenue Bulletins 2018–27 through 2018–52 is in Internal Revenue Bulletin 2018–52, dated December 27, 2018.

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