

Office of Chief Counsel
Internal Revenue Service
memorandum

Number: **20132701F**
Release Date: 7/5/2013

CC:LB&I:
POSTF-145772-11

UILC 199.06-00
1382.00-00

date: May 16, 2013

to: _____, Internal Revenue Agent
(Large Business & International)

from: Senior Counsel (_____)
(Large Business & International)

subject: DPAD as Deduction Against Nonpatronage-Sourced Income

This is in response to your request for our opinion as to whether, under the facts set forth below, _____ (hereafter the "Taxpayer") may use the increase in its domestic production activities deduction resulting from the reclassification of certain amounts previously characterized as grain purchases as PURPIMs to reduce its non-patronage taxable income for the years in issue. This memorandum may not be used or cited as precedent.

Please be advised that this writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney-client privilege. If disclosure becomes necessary, please contact this office for our views.

ISSUE

Whether the Taxpayer may use the increase in its domestic production activities deduction ("DPAD") under section 199 resulting from the reclassification of certain amounts previously classified as grain purchases as PURPIMs to reduce its non-patronage income for the year.

CONCLUSION

The DPAD resulting from the reclassification of the amounts previously classified as grain purchases as PURPIMs is a deduction incurred in connection with the conduct of patronage business and is inherently patronage-based. Therefore it can only be used to reduce patronage-sourced income, not nonpatronage-sourced income.

FACTS

The Taxpayer is a non-exempt cooperative subject to the provisions of Subchapter T of the Code. The Taxpayer is a large integrated and diversified agricultural concern that operates as both a grain marketing and agricultural supply cooperative. The Taxpayer has a fiscal and taxable year ending .

The Taxpayer markets grain on a patronage basis for its members, which include both farmer producers and local grain cooperatives. Taxpayer's grain marketing business consists of buying grain from members and nonmembers, handling and storing grain, processing grain, and selling grain or products produced from grain. The Taxpayer's grain marketing business is not conducted on a pooling basis. On its original returns for taxable years prior to its taxable year , the Taxpayer treated all payments made to members and nonmembers for grain as purchases and not as per-unit retain allocations paid in money (hereafter "PURPIMs"). As such, the grain purchases became part of the Taxpayer's cost of goods sold.

In of , the Taxpayer requested a private letter ruling respecting the treatment of its grain payments for purposes of sections 1382 and 199. In October of 2009, the Service issued a ruling to the Taxpayer holding that:

1. Grain payments to members and eligible nonmember patrons constitute "per-unit retain allocations paid in money" within the meaning of section 1382(b)(3) of the Code.
2. For purposes of computing its section 199 domestic production deduction, Taxpayer's qualified production activities income and taxable income should, pursuant to section 199(d)(3)(C) of the Code, be computed without regard to any deduction for grain payments to members and eligible nonmember patrons.

PLR 201002009 (2010 WL 147825). Beginning with its return, the Taxpayer treated payments for grain made to members and eligible nonmember patrons as PURPIMs and computed its DPAD under section 199 without regard to such payments.

In of , the Taxpayer filed an amended return for its taxable year seeking to increase its DPAD for the year by \$ based on the reclassification of amounts previously characterized as grain purchases as PURPIMs.

Similarly, in _____ of _____, the Taxpayer filed an amended return for its taxable year _____ seeking to increase its DPAD by \$ _____, again based on the reclassification of amounts previously characterized as grain purchases as PURPIMs. Because section 199(d)(3)(C) and the regulations thereunder provide that for purposes of computing the DPAD, taxable income and qualified production activities income (“QPAI”) are to be computed without regard to any deduction allowable under section 1382(b) or (c)(including, inter alia, the deduction for PURPIMs), the reclassification had the effect of increasing the Taxpayer’s DPAD. The increased DPAD deductions were wholly attributable to the Taxpayer’s patronage grain business.

As previously amended, the Taxpayer’s _____ return reflected patronage taxable income of zero and non-patronage taxable income (before NOL carryforward deductions) of \$ _____, which amount was reduced to zero by a non-patronage NOL carryforward deduction. The increased DPAD claimed on the amended return fully offset the non-patronage taxable income for the year and freed-up the patronage NOL carryforward deduction to be carried forward to later years.

The Taxpayer’s original _____ return reflected patronage taxable income of zero and non-patronage taxable income (before NOL carryforward deductions) of \$ _____, which amount was reduced to \$ _____ by a non-patronage NOL carryforward deduction of \$ _____. The increased DPAD claimed on the amended _____ return offset \$ _____ of the non-patronage taxable income for the year and freed-up \$ _____ of the patronage NOL carryforward deduction to be carried to later years.

LAW

Subchapter T and Patronage-Sourced Losses

For Federal income tax purposes, a nonexempt cooperative is a hybrid entity. As respects patronage-sourced income, it is taxed like a passthrough entity with its income being taxed only once, usually to the patron, but as to nonpatronage-sourced income, it is taxed like a C corporation with its income being fully taxable to the cooperative, and, if paid out to patrons, to the patrons as well. Farm Service Cooperative v. Commissioner, 619 F.2d 718, 723 (8th Cir. 1980).

Patronage-sourced losses cannot be used to offset nonpatronage-sourced income. Farm Service Cooperative, 619 F.2d 718 (8th Cir. 1980)(patronage-sourced NOL can only offset patronage-sourced income); Certified Grocers of California, Ltd v. Commissioner, 88 T.C. 238 (1987)(parent corporation’s patronage-sourced loss cannot offset other consolidated group members’ nonpatronage-sourced income). The prohibition against using patronage-sourced losses to offset nonpatronage-sourced income is not explicitly set out in the Code. Rather, it is inherent in the structure of Subchapter T and is necessary to preserve the “statutory distinction” between the tax treatments of the two types of income, *i.e.*, that patronage-sourced income is generally

not taxed at the cooperative level whereas nonpatronage-sourced income is. Farm Service Cooperative, 619 F.2d at 727. If a nonexempt cooperative could use a patronage-sourced loss to reduce its nonpatronage-sourced income, the effect would be to extend the tax benefit intended for patronage-sourced income to nonpatronage-sourced income. That is, nonpatronage-sourced income could be shielded from taxation at the cooperative level. See generally Buckeye Countrymark, Inc. v. Commissioner, 103 T.C. 547, 558-559 (1994), acq., 1997-1 C.B. 1; Landmark, Inc. v. United States, 25 Cl. Ct. 100, 106 (Cl. Ct. 1992).

The Eighth Circuit's opinion in Farm Service Cooperative is the leading case for the proposition that patronage-sourced losses cannot be used to offset nonpatronage-sourced income.¹ The taxpayer in that case was a nonexempt agricultural cooperative that divided its business activities into four categories: a broiler pool, a turkey pool, a regular pool, and "taxable activity." The regular pool sold farm supplies to both members and nonmembers. Taxable activity encompassed various miscellaneous sources of taxable income, such as gains from the sale of property, dividends on taxpayer-owned stock, and so forth. The broiler and turkey pools engaged in the production and processing of chickens and turkeys, respectively. Member growers in the broiler and turkey pools raised birds under contract with the taxpayer, received minimum payments for birds delivered (in the form of per-unit retains), and, in profitable years, patronage dividends. The taxpayer kept separate book and records for the three pools.

For the fiscal year 1971, the taxpayer in Farm Service Cooperative incurred a substantial loss on the broiler pool, but realized net income from its taxable activity, from the turkey pool, and from the regular pool (both as respects business conducted with members on a patronage basis and business conducted with nonmembers on a nonpatronage basis). The taxpayer distributed the net income from the turkey pool to the members of the turkey pool and that part of the net income of the regular pool attributable to business conducted on a patronage basis to the members of the regular pool, claiming a deduction under section 1382(b) for the amounts so distributed. It then offset that part of the net income of the regular pool attributable to business conducted on a nonpatronage basis as well as the income of the taxable activity against the broiler loss. A portion of the remaining broiler loss was then claimed as a NOL carryback deduction and applied against the taxpayer's taxable income for the three prior years.² For the fiscal year 1972, the broiler pool again sustained a loss, which loss the taxpayer again offset against that part of the net income of the regular pool attributable to business conducted on a nonpatronage basis and the income of the taxable activity. In short, for both 1971 and 1972, the taxpayer used the broiler pool losses (losses which

1

² In a footnote, the opinion states that the taxpayer charged the loss carryback to "an unallocated, general reserve account maintained for receipts from its taxable activities." Farm Service Cooperative, 619 F.2d at 721, fn 9.

were generated from business conducted on a patronage basis) to offset income which was not generated from business conducted on a patronage basis.

On audit, the Service determined that the taxpayer could not use the losses incurred by the broiler pool (i.e., losses incurred from business conducted on a patronage basis) to offset the income of the regular pool attributable to business conducted with nonmembers or the income of the taxable activity (i.e., income not generated from business conducted on a patronage basis). The Tax Court, however, held that the taxpayer could so use the broiler losses, and allowed the claimed carryback. Farm Service Cooperative v. Commissioner, 70 T.C. 145 (1978), rev'd, 619 F. 2d 718 (8th Cir. 1980). In so holding, the Tax Court relied on its decision in Associated Milk Producers, Inc. v. Commissioner, 68 T.C. 729 (1977), wherein it had held that a nonexempt cooperative could use a patronage-sourced NOL carryover to offset current year patronage-sourced income. The Eighth Circuit reversed, holding that “[a] nonexempt cooperative simply may not use patronage losses to reduce its tax liability on nonpatronage-sourced income.” Farm Service Cooperative, 619 F.2d at 727.

The Eighth Circuit’s rationale for holding that patronage-sourced losses cannot be used to offset nonpatronage-sourced income was rooted in the hybrid nature of a nonexempt cooperative; to wit, that a nonexempt cooperative is partially a passthrough entity and partially a taxable entity:

Sustaining taxpayer's position here would result in obliterating this statutory distinction. If patronage losses could be used to offset nonpatronage-sourced income, then a nonexempt cooperative could gain the tax advantages of an exempt cooperative without meeting the qualifications set forth in I.R.C. § 521(b). Not only would taxpayer itself gain the benefits of exemption - notably the exclusion of nonpatronage-sourced income from taxation - but all other cooperatives could do so as well. That is, any nonexempt cooperative could avoid tax on nonpatronage-sourced income by the simple expedient of operating at a loss on its patronage activities.

Farm Service Cooperative, 619 F.2d at 727. Later in the opinion, in distinguishing Associated Milk Producers from the case at hand, the Court explained that the taxpayer in Associated Milk Producers could use the patronage-sourced loss because while it was shifting the loss in time (a “vertical allocation”), it was still using it within the patronage business, whereas in Farm Service Cooperative, the taxpayer was attempting to impermissibly shift losses between the patronage and nonpatronage businesses (a “horizontal allocation”):

In our view, the vertical (i.e., chronological) allocation problem presented in Associated Milk Producers is quite distinct from the essentially horizontal allocation problem in this case. That patronage losses are involved in both cases should not obscure the significant differences

between them. Whereas in Associated Milk Producers the losses were borne by patrons, in this case taxpayer is trying to shift the broiler pool losses from the broiler pool patrons to itself and, more significantly, to the United States Treasury. Whereas the cooperative in Associated Milk Producers decided to forego its current patronage dividend deduction in charging off past losses, taxpayer in this case is seeking to avoid taxation on income for which no patronage dividend deduction is available.

Farm Service Cooperative, 619 F.2d at 724.

PURPIMs

As noted, for Federal income tax purposes, a nonexempt cooperative is a hybrid entity, taxed as a C corporation with respect to nonpatronage-sourced income, but generally treated as a passthrough entity with respect to patronage-sourced income. The mechanism by which a nonexempt cooperative operates as a passthrough entity is the deduction allowed the cooperative under section 1382(b) for amounts paid out to patrons in the form of patronage dividends, per-unit retain allocations, and so forth. Specifically as respects PURPIMs, section 1382(b)(3) allows a nonexempt cooperative a deduction for the taxable year for “per-unit retain allocations (as defined in section 1388(f)) to the extent paid in money . . . with respect to marketing occurring during such taxable year.” Section 1388(f) defines a “per-unit retain allocation” as “any allocation, by an organization to which Part I of this subchapter applies, to a patron with respect to products marketed for him, the amount of which is fixed without reference to the net earnings of the organization pursuant to an agreement between the organization and the patron.” A “patron” includes “any person with whom or for whom the cooperative association does business on a cooperative basis.” Treas. Reg. § 1.1388-1(e).

Domestic Production Activities Deduction

Section 199 provides for a deduction related to certain domestic production activities (the “DPAD”). For the taxable years at issue, the DPAD was equal to 3 percent of the lesser of the taxpayer’s taxable income (determined without regard to section 199) or its QPAI, limited to 50 percent of the taxpayer’s W-2 wage expense. I.R.C. § 199(a). A taxpayer’s QPAI is equal to the excess of its domestic production gross receipts over the sum of its cost of goods sold and other expenses, losses, and deductions properly allocable to such receipts. I.R.C. § 199(c)(1). “Domestic production gross receipts” include gross receipts which are derived from any sale of “qualifying production property which was manufactured, produced, grown, or extracted by the taxpayer in whole or significant part within the United States.” I.R.C. § 199(c)(4)(A)(i)(I). “Qualifying production property” includes tangible personal property. I.R.C. § 199(c)(5)(A). Thus a taxpayer that has gross receipts from the sale grain that it has grown within the United States may be entitled to a DPAD.

Several special rules apply in determining the DPAD of a “specified agricultural or horticultural cooperative.” Nonexempt cooperatives that market grain for their members qualify as specified agricultural or horticultural cooperatives. I.R.C. § 199(d)(3)(F).³ One of the special rules applicable to specified agricultural or horticultural cooperatives (known as the “cooperative attribution rule”) is that such organizations are treated as having “manufactured, produced, grown, or extracted . . . any qualifying production property marketed by the organization which its patrons have so manufactured, produced, grown, or extracted.” I.R.C. § 199(d)(3)(D). Thus, a specified agricultural or horticultural cooperative is generally treated as having produced the grain it markets for its patrons, with the result that it can include such grain sales in its domestic production gross receipts, thereby increasing its QPAI and, ultimately, its DPAD.

A second special rule applicable to specified agricultural or horticultural cooperatives (the “add back rule”) is that for purposes of determining their DPAD, such organizations’ taxable income and QPAI are computed without taking into account any deduction allowable under section 1382(b) or (c). I.R.C. § 199(d)(3)(C); Treas. Reg. §1.199-6(c). Section 1382(b) is the provision that grants nonexempt cooperatives a deduction for amounts paid to their patrons in the form of patronage dividends, PURPIMS, and the like, and is the mechanism which allows nonexempt cooperatives to function as passthrough entities with respect to patronage-sourced income. Excluding amounts deductible under section 1382(b) from taxable income and QPAI for purposes of the DPAD computation generally has the effect of substantially increasing a cooperative’s DPAD (subject to the W-2 wage limitation of section 199(b)(2)).

ANALYSIS

The refunds sought by the Taxpayer arise from the purported recharacterization of amounts the Taxpayer paid its patrons for grain from purchases to PURPIMS.⁴ Recharacterization of the purchases as PURPIMS would have the effect of increasing the Taxpayer’s DPAD. This is so because the DPAD is calculated as a percentage of the lesser of taxable income or QPAI, and because for purposes of calculating the DPAD of a specified agricultural or horticultural cooperative, taxable income and QPAI are computed without regard to the deduction allowable for PURPIMS under section 1382(b)(3). Assuming for the sake of argument that the purchases can properly be recharacterized as PURPIMS and thereby increase the Taxpayer’s DPAD, the increased DPAD cannot be used to offset the Taxpayer’s nonpatronage-sourced income as the

³ Section 199(d)(3)(F) defines a “specified agricultural or horticultural cooperative” as an organization to which Part I of Subchapter T (pertaining to cooperatives) applies which is engaged, *inter alia*, “in the marketing of agricultural or horticultural products.”

⁴ Examination has determined that the Taxpayer cannot, after the fact, recharacterize as PURPIMS amounts that were treated and understood to be payments at the time they were made. We concur in that conclusion, but do not discuss it herein.

increased DPAD is wholly attributable to the Taxpayer's patronage grain business and therefore can only be used to offset patronage-sourced income.

Because patronage-sourced losses cannot be used to offset nonpatronage-sourced income, nonexempt cooperatives must separately compute their patronage-sourced and nonpatronage-sourced income. We are unaware of any authority supporting the proposition that the DPAD, unlike all other deductions figuring into a nonexempt cooperative's income, need not be separately accounted for in computing the cooperative's patronage-sourced and nonpatronage-sourced income. While section 199 does not explicitly require that a nonexempt cooperative determine the deduction allowable thereunder separately for purposes of computing its patronage-sourced and nonpatronage-sourced income, neither does any other deduction provision of the Code. The same construct that requires the matching of patronage-sourced income with patronage-sourced expenses and nonpatronage-sourced income with nonpatronage-sourced expenses applies equally to the DPAD.

Beyond the general requirement that patronage-sourced and nonpatronage-sourced income be separately computed, separate DPAD computations for patronage-sourced and nonpatronage-sourced income are compelled by the special provisions of section 199(d)(3) for specified agricultural and horticultural cooperatives that the Taxpayer relies upon to claim the additional DPAD. The Taxpayer is entitled to the additional DPAD, if at all, by virtue of the cooperative attribution rule of section 199(d)(3)(D). It is the cooperative attribution rule which treats the Taxpayer as having grown the grain that was produced by its patrons but which it marketed on their behalf, thereby permitting the Taxpayer to include such sales in its domestic production gross receipts. In selling grain for its patrons, a nonexempt cooperative is conducting business on a patronage basis and the income or loss it realizes on such sales is inherently patronage-sourced. Sales subject to the cooperative attribution rule are necessarily business conducted on a patronage basis; sales that aren't wouldn't qualify for cooperative attribution rule, and therefore wouldn't qualify as domestic production gross receipts in the first instance.

Equally importantly, the Taxpayer's entitlement to the additional DPAD it claims is wholly dependent upon the reclassification of grain purchases as PURPIMs. It is this reclassification that allows the Taxpayer, under the add back rule of section 199(d)(3)(C) and Treas. Reg. §1.199-6(c), to increase its taxable income and QPAI for purposes of the DPAD computation. Under the add back rule, the taxable income of a specified agricultural and horticultural cooperative is determined without taking into account any deduction allowable under section 1382(b), including, *inter alia*, the deduction PURPIMs. A PURPIM is an "allocation," paid in money that a cooperative makes to a patron "with respect to products marketed for him." I.R.C. § 1388(f). An amount paid out as a PURPIM is, by definition, paid out in the course of the cooperative's patronage business - indeed, the deduction allowed by section 1382 is the mechanism by which a cooperative functions as a passthrough entity as respects patronage-sourced income. A DPAD attributable to PURPIMs and the add back rule

can only arise from the conduct of business on a patronage basis and therefore is inherently a deduction that can only be used in the computation of patronage-sourced income.⁵

A nonexempt cooperative cannot offset nonpatronage-sourced income with a patronage-sourced loss. Using a deduction that was incurred in the conduct of patronage business and that is inherently patronage-based to reduce nonpatronage-sourced income effectively is such an offset. The increased DPAD claimed by the Taxpayer arose out of the Taxpayer's patronage business and is inherently patronage-based. Applying it against nonpatronage-sourced income represents the type of horizontal allocation of losses prohibited by Farm Service Cooperative. To the extent the Taxpayer is entitled to the increased DPAD it claims, that DPAD can only be used to reduce patronage-sourced income, not nonpatronage-sourced income.

This advice has been coordinated with Branch 5 of Passthroughs & Special Industries. Please feel free to call me if you have any further questions respecting this matter.

Senior Counsel
CC:LB&I:

⁵ Such would be equally true as respects any other amount deductible under section 1382(b).