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Person To Contact: _____, ID No. _____

Telephone Number: _____

Refer Reply To:
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Date:
April 16, 2009

LEGEND:

Coop =

State A =

b =

Company =

c =

Dear _____:

This is in response to a request for rulings dated December 17, 2008, and subsequent correspondence, submitted by your authorized representative. The rulings concern the interplay of the rules in subchapter T of the Internal Revenue Code (concerning the taxation of cooperatives and their patrons) and the calculation of the section 199 deduction for certain cooperatives contained in section 199(d)(3).

Coop is a cooperative whose members are some _____ b growers growing b on approximately _____ acres of land each year in State A.

Shortly after it was formed, Coop requested and received a determination letter dated _____, confirming its status as an "exempt" section 521 farmers' cooperative. Thus, among other things, Coop is entitled to exclude or deduct

distributions to its members and other producers that qualify as per-unit retain allocations or patronage dividends provided the requirements of Subchapter T are met.

The b are a row crop which is planted each year in the spring. The harvest of the b begins around October 1. At harvest, the members of Coop truck their b to various receiving stations owned and operated by Coop. Coop currently has 15 strategically located stations. The b are stacked in large piles at the receiving stations until they are processed.

Coop then processes the b over a period of approximately to months at processing plants. The principal product is pure c, which is marketed in bulk form and in packaged form under certain brand names. Processing also results in several marketable by-products. The by-products are marketed through a cooperative known as Company of which Coop is a member.

In the fall of , member growers and nonmember producers delivered tons of b to Coop for processing. The b had been grown on approximately acres of land. The b processing began as the b were delivered and the processing "campaign" lasted through . The b were processed into approximately pounds of c. As described in greater detail below, Coop paid approximately \$ million to b growers for the b delivered in the fall of .

Coop is a cooperative corporation organized under the State A General Corporation Law. Corporations organized under that law are required to operate in accordance with a "cooperative plan" which is described as "a mode of operation whereby the earnings of the corporation are distributed on the basis of, or in proportion to, the value of property bought from or sold to shareholders and/or members or other persons...." Section 450.99.

Coop's Articles of Incorporation provide that its purposes are:

"...to receive, handle, manufacture, process and market the [b] and other agricultural products of its members and other producers; to purchase, handle, and distribute agricultural supplies and equipment to its members and other patrons; to perform any and all related services for its members and other patrons; and to engage in any other lawful purpose. This Cooperative shall be operated on a cooperative basis for the mutual benefit of its members and patrons." (Article III, Section 1).

Coop is organized with capital stock. Article IV, Section 1. Each person who is admitted to membership is required to pay \$ to purchase one share of membership common stock. Article IV, Section 2. Members are also required to purchase shares of patron preferred stock. Each share of patron preferred stock carries with it the right and obligation to deliver b from one acre of land. Article IV, Section 3. Neither the common stock nor the patron preferred stock is entitled to receive dividends. Article IV, Section 2

(common stock) and Section 3(a) (patron preferred stock). Only the common stock has the right to vote, and because each member of Coop owns one share of common stock, Coop is organized on a one-member, one-vote basis. Article IV, Section 2.

Coop's Articles of Incorporation require that "[a]ll net income (savings) of this Cooperative in excess of dividends and additions to reserves ... shall be distributed to members and patrons on the basis of patronage, as more particularly provided in the Bylaws." Article V.

Coop's Bylaws provide that it "shall be operated on a cooperative basis." Article VIII. They go on to state that "[u]pon delivering or selling or contracting to deliver or sell any products to this Cooperative ... each member shall be entitled to the patronage refunds, as described in these Bylaws, that arise out of the patronage transaction." Article VIII.

Most (over % of the crop) of the b that Coop processes and markets are grown by members (referred to as "Growers"). Coop also processes and markets some b grown by certain nonmembers (referred to as "Producers"). Coop does business with both Growers and Producers on a patronage basis and treats them alike for patronage purposes.

Coop does not process or market b grown by persons other than Growers and Producers.

Growers are required to enter into a Grower Agreement. Producers are required to enter into a Producer Agreement. The Grower Agreement and the Producer Agreement are identical in all material respects. Coop accepts b only from Growers and Producers and only as provided in the Grower or Producer Agreements.

Under the Grower Agreement, a Grower is permitted and obligated to grow (or cause to be grown) one acre of b for each share of patron preferred stock the Grower owns. Section 1 of the Grower Agreement. Growers owning shares of patron preferred stock in excess of the acres they plan to devote to b production are permitted to assign the growing rights attributed to those shares to nonmember growers (referred to as "Producers"). Under the Producer Agreement, those Producers are permitted and obligated to grow (or cause to be grown) one acre of b for each share of patron preferred stock with respect to which the Producer has been assigned growing rights. Section 1 of the Producer Agreement.

Growers and Producers are required to designate the land on which they will raise b for delivery to Coop each year. Section 1 of both Agreements. The Growers and Producers agree to deliver all b grown on the designated acreage to Coop. Section 3 of both Agreements.

When a Grower or Producer delivers b to a receiving station at the time of harvest, the b are weighed. The gross weight of the b is adjusted for dirt, stones, trash and other foreign substances (determined on a sampling basis), and a net weigh measured in tons is determined. Section 3 of both Agreements. The b are also tested at the time of delivery to determine their c content. Section 16(c) of the Grower Agreement.

Under both the Grower Agreement and the Producer Agreement, Growers and Producers are entitled to receive a payment “equal to the individual Grower’s net tons of [b] accepted by the Cooperative, multiplied by the price per net ton of [b] accepted.” Section 16(a) of the Grower Agreement. For purposes of this ruling request, this amount is referred to as the “b payment” (and as described below, b payments are made in the form of cash advances, a unit retain paid in a per-unit retain certificate, and a final settlement paid in cash).

The “price per net ton of [b] accepted” is determined on a pooled basis for each year’s b crop by dividing the total “proceeds” from that crop by the total net tons of b accepted. Section 16(b) of the Grower Agreement. The Grower Agreement and the Producer Agreement provide that the total “proceeds” is a net number – namely, the “amount after deducting from gross sales, all costs, charges, expenses, and margins (including reserves and unit retains but excluding payments to Growers) as are regularly and customarily deducted from gross sales in accordance with the Cooperative’s systems of accounting heretofore established.” Section 16(b) of the Grower Agreement.

Each Grower and Producer is entitled to receive the same amount per net ton of b delivered to each crop year, subject to an adjustment for c content. Section 16(c) of the Grower Agreement. Coop also offers certain incentives, including a relaxing of the c content standards and an early tonnage delivery premium, to encourage early delivery which allows Coop to more efficiently handle and process the b of all Growers and Producers. Sections 16(d) and (e) of the Grower Agreement.

The Grower Agreement and the Producer Agreement provide that Growers and Producers will receive b payment in installments.

The initial payment is an advance made in cash on or about _____ (for b delivered through _____) or on or about _____ (for b delivered after _____). Section 17(a) of the Grower Agreement. The second payment is an advance made in cash on the third Friday in _____. Section 17(b) of the Grower Agreement. Additional cash advances may be made “from time to time in such amounts as [Coop] may deem justifiable prior to final settlement.” Section 17(c) of the Grower Agreement.

Coop is authorized to withhold a unit retain from the price per net on of b accepted. The unit retain must “be evidenced in the records of the Cooperative by unit

retain credits in favor of the Grower.” Section 18(b) of the Grower Agreement. Growers are notified of the amount of the retain and issued a per-unit retain certificate during the payment period for the year. Coop’s per-unit retain certificates have been treated as “nonqualified” within the meaning of section 1388(i) of the Code.

The pool is closed at year end (). As soon as possible after the audited financial statements for the year are available, the final results of the pool are determined and a final settlement is made. The final payment for the b must be made by . Section 17(d) of the Grower Agreement. Customarily, Coop has made the final settlement payment in the form of cash (by check).

Thus, according to Coop, the b payments that Growers and Producers receive with respect to each crop are determined on a pooled basis and are of three types:

- Cash advances, made after the crop has been delivered and before the final settlement.
- A unit retain, withheld from the b payments and paid in the form of a nonqualified per-unit retain certificate.
- A final cash payment, made after the final settlement for the crop pool.

Coop’s Articles of Incorporation, Bylaws and Grower Agreements and Producer Agreements provide that, if Coop has any “net income (savings),” “annual income” or “annual savings,” then that amount will be paid to members and patrons as a “patronage refund.” See, Article V of the Articles of Incorporation, Article IX of the Bylaws, and Section 18(a) of the Grower Agreement.

This provision would come into play if, for some reason, Coop did not distribute all of its earnings as b payments some year. As a practical matter, all of Coop’s earnings have been shared on a patronage basis in the form of b payments, so it has had no income to pay as a “patronage refund,” and it has never paid a “patronage refund.”

In the event that Coop incurs a loss in any year, its Bylaws provide that the loss shall first be charged “against the capital reserves, if any.” Article XIV, Section 1. The Bylaws provide that if the loss exceeds the capital reserves and results from business done with or for members or patrons, then:

“...the Board of Directors of the Cooperative shall recover the loss from prior years’ annual savings from business done with or for members and patrons by charging the loss against the patronage credit accounts of the members and patrons whose patronage business generated the loss, on the basis of their patronage during the loss year.” (Article XIV, Section 2).

Coop has treated b payments made in cash as “purchases” for tax purposes and reported them on Schedule A, Line 2 of its Form 1120-C. The b payments made in the form of per-unit retain certificates have not been excluded or deducted on Coop’s Form 1120-C because the certificates are “non-qualified.”

Coop has not reported the advances made in cash as “per-unit retain allocations paid money” and therefore has not reported them on Schedule A, Line 4b of its Form 1120-C. It has not reported the cash payment of the final settlement as a patronage dividend paid in money on Schedule H, Line 3a of its form 1120-C.

Because of this reporting, b payments paid in cash have entered into the determination for tax purposes of the value of Coop’s inventories of c and by-products at year end.

Coop did not add back either b payments paid in cash or in the form of per unit retain certificates in its section 199 computations for its _____ and _____ fiscal years. Coop did not claim any section 199 deduction for any of those years, and consequently it has not passed through section 199 deduction to its Grower and Producer patrons in prior years.

Recent developments have cause Coop to reconsider how it should treat its b payments made in the form of cash for purposes of its tax return reporting and its section 199 computation.

Coop now believes that all b payments that are cash advances should be classified as “per-unit retain allocations paid in money.” It believes that the unit retains paid in the form of per-unit certificates should be classified as “per-unit retain allocations paid in certificates.” It believes that payment of the final settlement in cash should be treated as a “patronage dividend paid in money.”

Coop plans to begin reporting b payments in this manner, starting with its tax return for its fiscal year ended _____.

Beginning with its fiscal year ended _____, Coop plans to begin disregarding b payments made in cash for purposes of computing its qualified production activities income and its taxable income, and it plans to begin passing through to Grower and Producer patrons all or a portion of its section 199 deduction.

Based on the foregoing, Coop requests the following rulings:

1. The b payments paid in form of cash advances to Growers and Producers each year constitute “per-unit retain allocations paid in money” within the meaning of section 1382(b)(3) of the Code.

2. The b payments paid in cash each year as a final settlement constitute “patronage dividends paid in money” within the meaning of section 1382(b)(1) of the Code.
3. For purposes of computing its section 199 domestic production activities deduction, Coop’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 b payments paid in cash as advances or as a final settlement.

Subchapter T cooperatives are permitted to exclude or deduct distributions to their patrons that qualify as patronage dividends or per-unit retain allocations, provided those distributions otherwise meet the requirements of subchapter T of the Code.

Section 1388(f) of the Code defines the term “per-unit retain allocation” to mean “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 net earnings of the organization pursuant to an agreement between the organization and the patron.”

Per-unit retain allocations (PURs) may be made in money, property or certificates. Per-unit retain allocations paid in money and in property are excludable or deductible under section 1382(b)(3) of the Code. Per-unit retain allocations paid in certificates are deductible under section 1382(b)(3) if the certificates are qualified. If the certificates are nonqualified, the cooperative is permitted a deduction under 1382(b)(4) (or a tax benefit figured under section 1383) when the certificates are later redeemed.

Section 1388(a)(1) of the Code provides that the term “patronage dividend” means an amount paid to a patron by a cooperative on the basis of the quantity or value of business done with or done for such patron. Section 1388(a)(2) provides that a “patronage dividend” is an amount paid “under an obligation” that must have existed before the cooperative received the amount so paid. Section 1388(a)(3) provides that “patronage dividend” means an amount paid to a patron that is determined by reference to the net earnings of the cooperative from business done with or for its patrons. That section further provides that a “patronage dividend” does not include any amount paid to a patron to the extent that such amount is out of earnings other than from business done with or for patrons. Section 1.1382-3(c)(2) of the Income Tax Regulations states that income derived from sources other than patronage means incidental income derived from sources not directly related to the marketing, purchasing, or service activities of the cooperative association.

Section 1382(a) of the Code provides that, except as provided in section 1382(b), the gross income of any cooperative shall be determined without any adjustment (as a reduction in gross receipts, an increase in cost of goods sold, or otherwise) by reason of

any allocation or distribution to a patron out of net earnings or by reason of any amount paid to a patron as per-unit retain allocations.

Section 1382(b)(1) of the Code provides, in part, that in determining the taxable income of a cooperative there shall not be taken into account amounts paid during the payment period for the taxable year as patronage dividends to the extent paid in money, qualified written notices of allocation, or other property with respect to patronage occurring during such taxable year.

Section 1.1382-2(b)(1) provides, in part, that there is allowed as a deduction from the gross income of any cooperative to which part I of subchapter T applies, amounts paid to patrons during the payment period for the taxable year as patronage dividends with respect to patronage occurring during such taxable year, but only to the extent that such amounts are paid in money, qualified written notices of allocation, or other property (other than nonqualified written notices of allocation). Section 1388(d) of the Code defines the term “nonqualified written notices of allocation” as meaning a written notice of allocation other than a qualified written notice of allocation, or a qualified check that is not cashed on or before the 90th day after the close of the payment period for the taxable year for which the distribution of which it is part is paid.

Section 1382(b)(3) of the Code provides, in part, that in determining the taxable income of a cooperative there shall not be taken into account amounts paid during the payment period for the taxable year as per-unit retain allocations paid in money, other property, or qualified certificates with respect to marketing occurring during such taxable year.

Section 1382(e) of the Code provides that for purposes of section 1382(b), in the case of a pooling arrangement for marketing products, the patronage shall be treated as occurring during the taxable year the pool closes, and the marketing of products shall be treated as occurring during any taxable years the pool is open.

Though section 1382 of the Code is awkwardly drafted, the flush language of section 1382(b) clarifies what it means for an item not to be “taken into account.” It states that, “for purposes of this title,” a patronage dividend is treated as “an item of gross income and as a deduction therefrom,” and a per-unit retain allocation in money or qualified certificates are treated as a “deduction in arriving at gross income.”

Section 1382(d) of the Code provides, in part, that the payment period for any taxable year is the period beginning with the first day of such taxable year and ending with the fifteenth day of the ninth month following the close of such year.

Thus, per-unit retain allocations paid in money or qualified certificates are deductions in arriving at gross income if paid within the payment period for the taxable year. Because patronage dividends paid in money and qualified certificates are treated

as deductions in arriving at gross income, Form 990-C (and new Form 1120-C) requires such dividends to be reported on Schedule H as a deduction from gross income. Because a per-unit retain allocations paid in money or qualified certificates are treated as a “deduction in arriving at gross income” they are reported on Schedule A of the Form 990-C which represents the cooperative’s cost of goods sold. This does not change the fact that Coop is allowed a full deduction under section 1382(b) of the Code for per-unit retains paid in money or qualified certificates.

We note that, in order to prevent a cooperative from deducting the per-unit retain allocations made in money or qualified certificates for the second time when the associated product is sold, the cost of goods sold mechanism associated with inventory must be adjusted to reflect the deductions allowable under subchapter T. Specifically, cooperatives need to include the PURs in inventory cost for purposes of making inventory and section 263A of the Code computations and then adjust the ending inventory and cost of goods sold to prevent double deduction of the PURs. The adjustments can be made to either the inventory or the line item deduction for the PURs. In other words, if the PURs are deducted on a deduction line in the cooperative's tax return, they should be removed entirely from the ending inventory and cost of goods sold computed for the tax year. Alternatively, if the PURs are not deducted on a deduction line in the tax return, the PURs reflected in the ending inventory should be removed and included in the cost of goods sold amount for that tax year. This procedure will allow the cooperative to deduct the PURs once while also preserving the integrity of its section 263A calculation.

Under section 199(d)(3) of the Code, patrons that receive a qualified payment from a specified agricultural or horticultural cooperative are allowed a deduction for an amount allocable to their portion of the qualified production activities income (QPAI) of the organization received as a qualified patronage dividend or per-unit retain allocation which is paid in qualified per-unit retain certificates. In particular, section 199(d)(3)(F) requires the cooperative to be engaged in the manufacturing, production, growth, or extraction in whole or significant part of any agricultural or horticultural product, or in the marketing of agricultural or horticultural products. Under section 199(d)(3)(D), in the case of a cooperative engaged in the marketing of agricultural and horticultural products, the cooperative is treated as having manufactured, produced, grown, or extracted (MPGE) in whole or significant part any qualifying production property marketed by the cooperative that its patrons have MPGE (this is known in the industry as the “cooperative attribution rule”). In addition, section 199(d)(3)(A)(ii) requires the cooperative to designate the patron’s portion of the income allocable to the QPAI of the organization in a written notice mailed by the cooperative to its patrons no later than the 15th day of the ninth month following the close of the tax year.

Under section 1.199-6(c), for purposes of determining a cooperative’s section 199 deduction, the cooperative’s QPAI and taxable income are computed without taking

into account any deduction allowable under section 1382(b) or (c) of the Code (relating to patronage dividends, per-unit retain allocations, and nonpatronage distributions).

An agricultural or horticultural cooperative is permitted to “pass-through” to its patrons all or any portion of its section 199 deduction for the year provided it does so in the manner and within the time limits set by section 199(d)(3) of the Code. When a cooperative passes-through all or any portion of the section 199 deduction, the cooperative remains entitled to claim the entire section 199 deduction on its return (provided that it does not create or increase a patronage tax loss), but is required under section 199(d)(3)(B) to reduce the deduction or exclusion it would otherwise claim under section 1382(b) for per-unit retain allocations and patronage dividends.

Section 1.199-6(l) provides that a qualified payment received by a patron of a cooperative is not taken into account by the patron for purposes of section 199.

Section 1.199-6(e) defines the term qualified payment to mean any amount of a patronage dividend or per-unit retain allocation, as described in section 1385(a)(1) or (3) of the Code received by the patron from a cooperative, that is attributable to the portion of the cooperative’s QPAI, for which the cooperative is allowed a section 199 deduction. For this purpose, patronage dividends and per-unit retain allocations include any advances on patronage and per-unit retains paid in money during the taxable year.

Section 1.199-6(k) provides that section 1.199-6 is the exclusive method for the cooperative and its patrons to compute the amount of the section 199 deduction.

The effect of these sections is that the cooperative will compute the entire section 199 deduction at the cooperative level and that none of the distributions whether patronage dividends or per-unit retain allocations received from the cooperative will be eligible for section 199 in the patron’s hands. That is, the patron may not count the qualified payment received from the cooperative in the patron’s own section 199 computation whether or not the cooperative keeps or passes through the section 199 deduction. Accordingly, the only way that a patron can claim a section 199 deduction for a qualified payment received from a cooperative is for the cooperative to pass-through the section 199 amount in accordance with the provisions of 199(d)(3) of the Code and the regulations thereunder.

Coop’s b payments paid in form of cash advances qualify as per-unit retain allocations within the meaning of section 1388(f) of the Code because they were distributed with respect to b that Coop markets for its patrons, and by the fact that the patrons receive the payments based on the quantity of b delivered; the b payments are determined without reference to the Coop’s net earnings; the b payments were paid pursuant to a contract with the patrons establishing the necessary pre-existing agreement and obligation; and the b payments were paid within the payment period of section 1382(d).

Based on the foregoing, we rule as requested that::

1. The b payments paid in form of cash advances to Growers and Producers each year constitute “per-unit retain allocations paid in money” within the meaning of section 1382(b)(3) of the Code.
2. The b payments paid in cash each year as a final settlement constitute “patronage dividends paid in money” within the meaning of section 1382(b)(1) of the Code.
3. For purposes of computing its section 199 domestic production activities deduction, Coop’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 b payments paid in cash as advances or as a final settlement.

No opinion is expressed or implied regarding the application of any other provisions of the Code or regulations. Specifically, no opinion is expressed or implied regarding Coop’s reporting of patronage dividends under section 6044 of the Code.

This ruling is directed only to the taxpayer that requested it. Under section 6110(k)(3) of the Code it may not be used or cited as precedent. In accordance with a power of attorney filed with the request, a copy of the ruling is being sent to your authorized representative.

Sincerely yours,

Paul F. Handleman

Paul F. Handleman
Chief, Branch 5
Office of the Associate Chief Counsel
(Passthroughs & Special Industries)