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Date:
July 09, 2009

LEGEND:

Coop =

State A =

b =

c =

d =

e =

f =

Dear _____ :

This is in response to a request for rulings dated March 6, 2009, 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 farmers' cooperative organized as a cooperative corporation under State A law.

Coop markets b for its farmer members. During Coop's b sales were \$. Principal commodities marketed in were c (\$) and d (\$). Coop also marketed e (\$) and f (\$) during the year.

Coop also provides a broad range of the farm supplies to its farmer members, including petroleum products (such as diesel fuel, propane, heating oil, and gasoline), plant food (fertilizers), agricultural chemicals (herbicides and pesticides), feed, and seed. During , Coop's farm supply sales totaled approximately \$.

As described in greater detail below, Coop's "members" are farmers who do business with it. Each member owns one share of Coop's capital stock (par value \$100) and is entitled to share in the net earnings of Coop in the form of patronage dividends. Coop currently has approximately members.

Persons who are not farmers, but who wish to do business with Coop on a patronage basis, are eligible to become "participating patrons" of Coop. Each participating patron is required to own a Certificate of Participation (stated dollar amount \$100) and is entitled to share in the net earnings of Coop in the form of patronage dividends. Participating patrons do not have voting rights. Coop currently has approximately participating patrons.

Coop is organized as a cooperative corporation pursuant to Sections to of the State A Statutes. These sections contain the basic requirements for cooperative operation. To the extent not inconsistent with what is provided in these sections, cooperative corporations are governed generally by the Business Corporation Act of State A.

Section provides that cooperative corporations are formed "by the adoption of articles of incorporation in the same manner and with like powers and duties required of other corporations except as provided in sections ."

Section required that, among other things, a cooperative corporation must include in its articles of incorporation:

"...(2) That dividends on the capital stock shall be fixed but shall not exceed eight percent per annum of the amount actually paid thereon; (3) That the net earnings or savings of the company remaining after making

the distribution provided in subdivision (2) of this section, if any, shall be distributed on the basis of or in proportion to the amount or value of the property bought from or sold to members, or members and other patrons, or of labor performed or other services rendered to the corporation... (4) That the articles of incorporation or the Bylaws of the company shall give a detailed statement of the method followed in distributing earnings or savings..."

Section enumerates various powers that cooperative corporations may exercise, including the power "(6) to set aside each year to a surplus fund a portion of the savings of the company over and above all expenses and dividends or interest upon capital stock which surplus may be used for conducting the business of the corporation."

Coop's Revised Articles of Incorporation provides that it is organized on a stock basis. Stock may be owned only by:

"...persons, including both landlords and tenants in share tenancies who are bona fide producers of agricultural products in the trade territory served by this corporation, who patronize the corporation annually."
(Article , Section 4).

As noted above, these persons are the members of Coop and are referred to in this ruling as "members." Each stockholder is entitled to no more than one vote. (Article , Section 3). Persons not eligible to own capital stock, but wanting to do business with Coop on a patronage basis, are permitted to become "participating patrons" and to hold a "Certificate of Participation." Such persons have "all the rights and privileges of a shareholder" (i.e., they are entitled to share in patronage dividends), except they may not vote. (Article , Section 5).

Article of the Revised Articles of Incorporation provides general rules governing the allocation and distribution of earnings:

"Section 1. After deducting all expenses which are lawfully deductible or excludable in determining the net margins of the corporation, the board of directors shall establish and deduct reasonable amounts for reserves, at such rates as shall be provided by the By-laws of the corporation.

Section 2. From the balance remaining after complying with Section 1, as authorized in the By-laws, the board of directors may pay dividends on the paid up capital stock at a rate not to exceed eight percent (8 percent) per annum, provided, however, that dividends on such stock shall be non-cumulative from year to year.

Section 3. The remaining net margins, after providing for the deductions under sections 1 and 2 of this article, shall belong to and be held for the stockholders and patrons and shall be apportioned among them on a patronage basis at the close of each fiscal year, as provided by the By-laws of the corporation. The By-laws of the corporation shall give a detailed statement of the methods to be followed in distributing earnings or savings.”

Article of Coop’s By-laws provides a detailed statement of the methods to be followed in the distribution of savings.

Section 1 defines the term “net margins.” The gross receipts of this Cooperative shall include all proceeds from commodities marketed for patrons, plus all sums received for supplies and equipment and services procured for patrons, plus all income from all other sources. From the gross receipts shall be deducted all costs and expenses and other charges which are lawfully excludable or deductible from this Cooperative’s gross income for the purpose of determining the amount of margins for the period.

As described in greater detail below, in determining “net margins” for this purpose, Coop deducts what it pays (other than patronage dividends) to members for the b that it markets for them on a patronage basis.

Though Article of the Revised Articles of Incorporation provides that dividends may be paid on capital stock, Section 2 provides that no dividends shall be paid on capital stock, and, as a result, net margins are not reduced by dividends.

Section 3 provides that the net margins shall be reduced “by margins attributable to business done with persons who are not stockholders or participating patrons and from non-patronage sources” and by other reasonable reserves for necessary business purposes.

Section 4 then provides that the balance of said margins which remain shall be deemed to be patrons net margins. All of the patrons’ net margins shall, as received by the Cooperative, belong to and be held for the patrons and shall be apportioned among them on a patronage basis at the close of each fiscal year.

Section 5 provides that allocation unites may be used in determining how to apportion net savings on a patronage basis. Coop uses a single allocation unit for b marketing business, allocating patronage dividends on the basis of bushels of b marketed through Coop. Coop accounts for its b storage business in a separate allocation unit, allocating patronage dividends on the basis of storage fees paid to Coop. Coop currently uses three allocation units for its supplies business – (i) merchandise and feed, (ii) fertilizer, chemical and seed, and (iii) petroleum. Each of the supplies

allocation units allocates patronage dividends based upon dollars of purchases from Coop of products sold by the unit.

Section 6 requires the allocated amount be paid to patrons, but permits the Board to pay a portion of the patronage dividend in written notices of allocation (referred to by Coop as "Members' Equity Credits").

Article of Coop's By-laws provides that upon dissolution assets will first be used to pay all debts and liabilities. Remaining assets will then be distributed to the holders of Members' Equity Credits in an amount equal to the stated dollar amount of the Credits. The holders of capital stock and Certificated of Participation will then be entitled to receive what they paid for them. Any residual assets then remaining will be shared on a patronage basis "among the equity holders on the basis of their respective deferred patronage accounts as shown on the records of the cooperative insofar as possible."

In the event that Coop incurs a loss, Section 7 of Article authorizes Coop (among other things) to "charge such loss against the Members' Equity Credits and other equity held by those stockholders and participating patrons whose patronage gave rise to such loss."

This letter relates to Coop's b marketing activities. Coop operates b elevators located throughout the territory it serves. Collectively, the elevators have the capacity to store approximately bushels of b. Coop's elevators located along rail lines tend to be larger and to have more storage capacity than Coop's truck facilities. Most are capable of loading 100-car trains used to ship b long distances to market. From the elevators, Coop is able to reach multiple domestic markets for b. From Coop's elevators served by truck, b can be sold to local users. B from the truck elevators can also be transferred to Coop's rail facilities for shipment by rail when the market dictates.

In very simple terms, Coop's b marketing business on behalf of its members consists of buying b from members, handling and storing the b at its elevators, and then selling the b to customers.

The issues in this ruling relate to the characterization for purposes of subchapter T of the Code and section 199 of payments that Coop makes to its members and participating patrons when it acquires their b for marketing on a patronage basis. The payments that are the subject of this ruling (referred to as "b payments") are amounts paid in cash to members and participating patrons for b delivered to Coop for marketing on a patronage basis. As the term is used in this ruling, "b payments" do not include any amounts that Coop may pay to persons who are not members or participating patrons. Also, as the term as used in this ruling, "b payments" do not include patronage dividends paid to members and participating patrons with respect to b marketed for them.

Coop does not operate on a pooling basis. Thus, in contrast to cooperatives that use pooling, the members of Coop do not commit to deliver all of the b they grow from specified acreage to Coop to be pooled with the b of other members. Coop's members retain the commodity price risk until they decide to sell their b to Coop for marketing – the price risk does not shift to a pool after harvest as it does for pooling cooperatives. All marketing proceeds are not shared equally on the basis of patronage, in the form of harvest advances and progress payments with a final settlement when the pool closes.

Rather, Coop pays each member a market price for his or her b determined individually as described below. Payments are made in cash and occur throughout the year as members sell b to Coop for marketing on a cooperative basis. Coop then markets each member's b along with the b of all of its members in the manner it thinks will produce the best return. Finally, after net earnings for the year are determined (subtracting b payments in this determination), Coop pays a patronage dividend to its members with respect to their b.

This system of operation and marketing means that two members that market the same quantity and quality of b through Coop during any year will likely receive different b payments, though they will receive the same patronage dividend.

Coop offers members several choices when they sell their b to Coop for marketing on a cooperative basis. Members can: (i) sell b to Coop in a spot sale at the current elevator bid price, (ii) sell b to Coop using a forward contract, (iii) sell b to Coop using a basis contract, and (iv) sell b to Coop using hedge-to-arrive contract. The first and second alternatives are the ones most commonly used by members. Basis and hedge-to-arrive contracts are less common.

Coop offers different alternatives to accommodate the desire of many members who want to retain as much flexibility as possible to determine when and how to sell their b. The alternatives that Coop offers are similar to the choices offered farmers by commercial b companies, though of course, commercial b companies do not market b on a patronage basis and pay patronage dividends.

One way to sell b to Coop for marketing on a patronage basis is to sell the b to Coop in a spot sale at the bid price. All country elevators have posted bid prices. The cash bid prices vary from day to day. The variations are in response to developments in the b markets (and future exchanges). Those markets are very active. Cash bid prices also vary during each day.

It is usually not advantageous for farmers to simply deliver b to sell it at the posted cash bid prices at the time of harvest since prices normally are lowest at the time. Some farmers have the capacity to store b on their farms and can deliver the b later when they believe the price is right. Many farmers deliver b to an elevator for

storage (and pay the elevator storage fees), retaining ownership of the b until they believe the bid price is right.

The most popular way for members to sell their b to Coop is by forward contract (sometimes also referred to as a “to arrive” contract). Forward contract calls for a delivery of a specified quantity and quality of b, at a specified location, during a specified time period. Forward contracts also specify the price that is to be paid for the b. Forward contracts can be entered into before b is planted or while it is growing.

Farmers interested in entering into a forward contract with Coop can determine the price Coop is willing to pay at its various elevators during various periods of time in the future from Coop’s cash b bid schedule. When a b company purchases b from a member pursuant to a forward contract, ownership of the b passes to the company at the time of delivery under the contract and ordinarily payment is then due.

A farmer can contract to sell his b to Coop at the time of harvest (or at some other time) under a basis contract. These contracts are sometimes used by Coop and its members, but are not as popular as forward contracts and selling b in spot sales.

Basis contracts allows a farmer, who believes that the future price of b will increase in the months after he or she enters into the contract, to defer setting the cash price until a later date. Contracts governing these arrangements specify the shipment period and time period during which the farmer has the option of asking that his or her b be priced. When the farmer elects to price the b, the price is the futures price on that day plus or minus an agreed amount specified in the contract and referred to as the “basis.”

Yet another option available to a farmer is to enter into a “hedge-to-arrive contract.” While not as popular as forward contracts, some of Coop’s members prefer to sell their b to Coop under these contracts.

Operating in the manner described above, Coop made b payments in excess of \$ _____ to members during _____ for b purchased in spot sales or pursuant to forward, basis and hedge-to-arrive contracts. Coop’s _____ b patronage dividend was \$ _____. It was paid 50 percent in cash and 50 percent in qualified written notices of allocation (using Members’ Equity Credits). Coop has treated b payments made in cash to members as “purchases” for tax purposes and reported them on Schedule A, Line 2 of its Form 1120-C.

Coop has not reported b payments made in cash as “per-unit retain allocations paid in money” and, therefore, has not reported them on Schedule A, Line 4b of its Form 1120-C. It has reported the patronage dividends paid to b members as a patronage dividend paid in money and qualified written notices of allocation on Schedule H, lines 3a and 3b of its Form 1120-C.

Because of this reporting, b payments paid in cash have entered into the determination of Coop's cost of goods sold for tax purposes. As is customary in the b business, Coop values its b inventories at year end at market for financial statement and for tax purposes.

Coop has done a section 199 computation in prior years. In that computation, it has added back patronage dividends as permitted by section 199(d)(3)(C) of the Code, but it has not added-back b payments paid in cash. Coop has not passed through any portion of its section 199 deduction to members in prior years.

Coop is seeking rulings to confirm that all b payments in cash to members and participating patrons should be classified as "per-unit retain allocations paid in money" and that they should be added back in its section 199 computation.

Coop request the following rulings:

1. Coop's b payments to members and participating patrons constitute "per-unit retain allocations paid in money" within the meaning of section 1382(b)(3) of the Code.
2. For the purpose 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 to members and participating patrons.

Nonexempt 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 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 sections 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.

Patronage dividends may be paid in money, property or written notices of allocation. Patronage dividends paid in money and in property are excludable or deductible under section 1382(b)(1) of the Code. Patronage dividends paid in written notices of allocation are deductible under section 1382(b)(1) if the written notices of allocation are qualified. If the notices are nonqualified, the cooperative is permitted a deduction under sections 1382(b)(2) (or a tax benefit figured under section 1383) when the notices are later redeemed.

Section 1388(b) provides that the term “written notice of allocation” means any capital stock, revolving fund certificate, retain certificate, certificate of indebtedness, letter of advice, or other written notice, which discloses to the recipient the stated dollar amount allocated to him by the organization and the portion thereof, if any, which constitutes a patronage dividend.

For cooperatives that use pooling, Rev. Rul. 67-333, 1967-2 C.B. 299, provides that pool advances are treated as per-unit retain allocations and the final pool payment, made after net earnings have been determined, is treated as a patronage dividend.

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) of the regulations, 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 199(d)(3)(A) of the Code provides that a cooperative passes through an amount of its section 199 deduction by "identifying" such amount in a written notice mailed to such person during the payment period described in section 1382(d). Section 1382(d) provides that the payment period for a 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.

Section 1.199-6(g) of the regulations provide that in order for a patron to qualify for the section 199 deduction, § 1.199-6(a) requires that the cooperative identify in a written notice the patron's portion of the section 199 deduction that is attributable to the portion of the cooperative's QPAI for which the cooperative is allowed a section 199 deduction. This written notice must be mailed by the cooperative to its patrons no later than the 15th day of the ninth month following the close of the taxable year. The cooperative may use the same written notice, if any, that it uses to notify patrons of their respective allocations of patronage dividends, or may use a separate timely written notice(s) to comply with this section. The cooperative must report the amount of the patron's section 199 deduction on Form 1099-PATR, "Taxable Distributions Received From Cooperatives," issued to the patron.

While a cooperative is permitted to disregard per-unit retain allocations and patronage dividends in its section 199 deduction, §1.199-6(l) of the regulations provide 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) of the regulations define 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.

Coop is a "specified agricultural or horticultural cooperative" within the meaning of section 199(d)(3)(F) of the Code and §1.199-6(f) of the regulations. Coop is an organization "to which Part I of subchapter T applies." It is engaged in the marketing of agricultural or horticultural products (i.e., b of its members, which it markets, and various farm supplies, which it sells to members).

As a specified agricultural or horticultural cooperative, Coop is entitled to the benefit of section 199(d)(3)(C) of the Code and § 1.199-6(c) of the regulations which permit such cooperatives to disregard deductions under section 1382(b) and (c) for purposes of computing qualified production activities income and taxable income for section 199 purposes. Section 1382(b) provides deductions for per-unit retain allocations paid in money, property and qualified per-unit retain certificates as well as for patronage dividends paid in money, property and qualified written notices of allocation. It also provides for deductions when nonqualified per-unit retain certificates and nonqualified written notices of allocation are redeemed.

The effect of the section 199 provisions is that a 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 does not operate on a pooling basis. Coop purchases b from its members and markets that b. The amount that each member receives when it sells b to Coop for marketing depends upon how and when the member chooses to sell that b to Coop.

Members are not required to deliver their b to Coop. They are free to sell as little or as much of their b to Coop as they choose.

Members have a number of options for determining how and when sales are made. As a result, two members delivering the same amount of b to Coop during any year will be paid different amounts for that b depending upon how and when they sell the b. However, all members share in Coop's net earnings from member b operations in proportion to the number of bushels of b they market through Coop. Those net

earnings are distributed after the end of each year in the form of patronage dividends paid in cash and qualified written notices of allocation.

The question presented by this ruling is whether the b payments made by Coop to members for b qualify as per-unit retain allocations paid in money within the meaning of section 1388(f) of the Code. Under section 199 and § 1.199-6 of the regulations, the answer to this question determines who gets to include the b payments in the section 199 computation. If the b payments to members are per-unit retain allocations paid in money, then they should be added-back in Coop's section 199 computation and not included in the members' section 199 computations. If the b payments to members are not per-unit retain allocations paid in money, then they should not be added-back in Coop's section 199 computation, but should be included in the members' section 199 computations. These results are the same whether Coop decides to keep or to pass-through all or a portion of its section 199 deduction.

According to Coop, b marketing cooperatives like Coop have never thought of b payments as per-unit retain allocations paid in money. However, Coop's b payments appear to meet the definition of "per-unit retain allocations paid in money" which are excludable or deductible under section 1382(b)(3) of the Code.

As described above, the b payments are made in cash so the "paid in money" requirement is met. Coop's b payments also meet all the requirements of the definition of "per-unit retain allocation" contained in section 1388(f) of the Code, which 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 the net earnings of the organization pursuant to an agreement between the organization and the patron.

First, Coop's b payments are paid "pursuant to an agreement," namely the particular agreement applicable to the method the member uses to determine how and when his or her b is sold to Coop. For example, if b is sold by a member to Coop in a spot sale at the current bid price, there is a written agreement between the member and Coop embodied in the Purchase Settlement.

Second, Coop's b payments to a member are made "with respect to products marketed for him," namely, the b delivered by the member for marketing by Coop. As described above, Coop markets the b it acquires from members, and members share in Coop's net earnings from its marketing activities in the form of patronage dividends.

Third, the amount of the b payments to each member "is fixed without reference to the net earnings" of Coop since, at the time the payments are made, Coop's actual net earnings for the year are neither known or determinable.

While per-unit retains are often made on the basis of a specified amount per unit of product marketed, what is important is that they not be made with respect to net earnings. See Rev. Rul. 68-236, 1968-1 C.B. 382, which observed:

“Thus, to constitute a per-unit retain allocation, the allocation need not be made strictly on the basis of a specified amount per-unit of product marketed provided it is made with respect to products marketed for the patron and not with respect to the net earnings of the organization. Whether an allocation meets the foregoing description will be a question of fact.”

The fact that all members do not receive the same payments for their b (i.e., that Coop does not pool) does not mean that b payments should not be treated as per-unit retain allocations paid in money. In Farm Service Cooperative v. Commissioner, 619 F. 2d 718 (8th Cir. 1980), rev'g Farm Service Cooperative v. Commissioner, 70 T.C. 145 (1978), the Eighth Circuit Court of Appeals characterized payments to Farm Service's poultry growers as per-unit retain allocations paid in money, even though they were determined under a formula that resulted in some poultry growers receiving more than others depending upon the efficiency of their operations and the market price of chickens when they delivered their chickens to Farm Service. The Tax Court described the formula as follows:

“The grower was paid by petitioner for growing chickens based on the delivery weight to the processing plant, less the weight of chickens condemned by the U.S. Department of Agriculture. The formula under which the grower was paid also took into account variable market rates for full grown chickens, and an efficiency factor that related the number of pounds of feed to the pounds of chickens produced. The efficiency factor was figured into the grower's compensation because Farm Service supplied all chicken feed. Under the contract provisions established with each of the growers, there was also a guaranteed minimum amount the grower would receive from the cooperative irrespective of wholesale market variations. For example, the contract in effect on July 1, 1968, provided that ‘In no event will the Grower Member receive less than 1.25 cents per pound less U.S.D.A. condemnation.’ On its books, petitioner treated payments to its growers as a cost of production.”

70 T.C. at 147-148.

Historically, Coop represents that it has treated its b payments as “purchases,” not as “per-unit retain allocations paid in money.” It is clear under section 199 of the Code and §1.199-6 of the regulations that marketing cooperatives that pool can treat all of their grower payments (other than the final patronage dividend) as per-unit retain allocations. We do not see why marketing cooperatives that do not pool should be treated differently.

Section 1382(b)(3) of the Code provides that, in order for a per-unit retain allocation paid in money, qualified per-unit retain certificates or property to be deductible for a year, it must be paid with respect to marketing occurring during such taxable year. There is nothing in the Code or regulations specifying when “marketing” occurs in the case of cooperatives that do not pool. For pooling cooperatives, section 1382(e)(2) provides that “the marketing of products shall be treated as occurring during any of the taxable years in which the pool is open.”

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 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 1120-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 of the Code. Specifically, cooperatives need to include the per-unit retain allocations 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 per-unit retain allocations. The adjustments can be made to either the inventory or the line item deduction for the per-unit retain allocations. In other words, if the per-unit retain allocations 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 per-unit retain allocations are not deducted on a deduction line in the tax return, the per-unit retain allocations 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 per-unit retain allocations once while also preserving the integrity of its section 263A calculation.

Coop’s b payments 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; 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. Coop's b payments to members and participating patrons constitute "per-unit retain allocations paid in money" within the meaning of section 1382(b)(3) of the Code.
2. For the purpose 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 to members and participating patrons.

No opinion is expressed or implied regarding the application of any other provision in the Code or regulations. The conclusions set forth in this ruling are limited to b payments made during a taxable year attributable to b which is sold by Coop during the taxable year. Specifically, no opinion is expressed or implied as to whether b payments made during a taxable year attributable to b which is in inventory at year-end qualify as per-unit retain allocations paid in money.

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)