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Refer Reply To:
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Date:
August 12, 2009

LEGEND:

Taxpayer =

State A =

b =

Dear _____:

This is in response to a request for ruling dated March 27, 2009 submitted by your authorized representative. The ruling concerns 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).

Taxpayer is a farmer-owned cooperative organized and operating for the benefit of its member-patrons under State A law. Taxpayer is primarily engaged in the procurement, processing, marketing, and transportation of b and b products. The b are processed into two primary products, b used as and b which is further processed for human consumption. Processing also yields a host of co-products. Taxpayer operates b processing plants in

and _____, on a 24 hour/7 days a week basis, and sells its products to a broad range of customers involved in food processing, merchandising agricultural commodities, livestock production, and renewable fuels marketing.

Taxpayer is a federated cooperative comprised of local farmer-owned grain handling cooperatives and regional cooperatives. Under its articles of incorporation, only bona fide cooperative associations of agricultural producers are eligible for membership. Each member has one vote in the governance of the cooperative.

The members deliver b to Taxpayer's plants by truck or rail, where they are immediately graded, commingled, crushed, further processed and marketed. In accordance with its bylaw obligation, Taxpayer computes annual net earnings from business with member-patrons, determines the patronage refund amount and converts it to an average rate per bushel of b. Each member receives an annual patronage refund equal to bushels delivered multiplied by the patronage refund rate.

Taxpayer's bylaws, in , provide that the terms and conditions of each patronage transaction with a member, whether or not expressly referred to in such transaction, include Taxpayer's obligation to pay such member an annual percentage refund determined with reference to Taxpayer's net earnings from patronage at year end.

Members deliver their b to Taxpayer's plants subject to the terms and conditions of written "purchase contracts". A purchase contract may cover a single delivery, or extend to multiple shipments. The terms of a purchase contract are negotiated and agreed to by the member and Taxpayer in advance of delivery. The contract price is negotiated with reference to the current Chicago Board of Trade market price per bushel. The price per bushel is subject to adjustment for (1) discounts based on moisture, foreign material, damage, low test weight, mold, insects, and other factors, and (2) premiums relating to content, and for

b.

A check for the adjusted contract price per bushel, known as the "b settlement," is issued to the member after delivery in accordance with grain industry rules and state law. For the fiscal years ended and b settlement payments to members totaled \$ and \$, respectively. Patronage refunds of net earnings from processing and marketing member b deliveries for fiscal and fiscal were \$ and \$, respectively.

Taxpayer maintains a single pool to determine its annual patronage refund obligation to members for b delivered, processed and sold. A separate pool is opened for each fiscal year. Taxpayer uses the closed pool method in its financial statement and tax return, and has always capitalized the b settlements into inventory. Ending inventory includes the capitalized b settlements amount adjusted to the lower of cost or net realizable value (after considering processing costs).

Under the closed pool method, Taxpayer effectively sells the ending b inventory forward to the next year and measures its fiscal year pool profit at the lower of cost or net realizable value. This means that the product on hand at the end of the fiscal year is sold forward to the next year's pool at the lower cost or net realizable value and the next year's pool will realize the benefit or cost of any difference between the lower cost or net realizable value amount and the actual proceeds from the sale of b products. Year end b inventory includes less than days purchases, days in fiscal and days in fiscal .

Taxpayer's financial statements reflect the b settlement payments to members as part of cost of goods sold. Therefore, only the final payment, or patronage dividend, is reflected as part of net income. The presentation on the tax return is consistent with the financial statements. Form 1120-C requires Taxpayer to report per-unit retains paid in money in Schedule A (cost of goods sold). As discussed below, this does not change the fact that the full amount of the b settlements and patronage dividend are section 1382(b) amount paid within the payment period for the taxable year and may be deducted on the income tax return and added back for purposes of computing the section 199 deduction.

Taxpayer requests the following rulings:

1. The b settlement amounts that Taxpayer pays to its member farmer cooperatives for b delivered to Taxpayer constitute "per-unit retain allocations paid in money" within the meaning of section 1382(b)(3) of the Code.
2. In computing Taxpayer's section 199 domestic production activities 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 the b settlements.

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 (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.

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 with respect to an open pool 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 Taxpayer 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 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 is 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 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 Income Tax 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 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.

Taxpayer's b settlements qualify as per-unit retain allocations within the meaning of section 1388(f) of the Code because they are (1) distributed with respect to b that Taxpayer markets for its patrons; (2) the patrons receive the payments based on the quantity of b delivered; (3) the b settlements are determined without reference to Taxpayer's net earnings; (4) the b settlements are paid pursuant to a contract with the patrons establishing the necessary pre-existing agreement and obligation; and (5) the b settlements are paid within the payment period of section 1382(d). Such per-unit retains are to be reported in box 3 of Form 1099-PATR, "Taxable Distributions Received From Cooperatives."

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

- 1 The b settlement amounts that Taxpayer pays to its member farmer cooperatives for b delivered to Taxpayer constitute "per-unit retain allocations paid in money" within the meaning of section 1382(b)(3) of the Code.
- 2 In computing Taxpayer's section 199 domestic production activities 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 the b settlements.

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)