

Internal Revenue Service

Department of the Treasury
Washington, DC 20224

Number: **200949018**
Release Date: 12/4/2009

Third Party Communication: None
Date of Communication: Not Applicable
Person To Contact:

Index Number: 1382.00-00, 199.06-00

Telephone Number: _____, ID No. _____

Refer Reply To:
CC:PSI:B05
PLR-121165-09
Date:
August 31, 2009

LEGEND:

Taxpayer =

State A =

b =

c =

Dear _____:

This is in response to a request for rulings dated April 16, 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).

Taxpayer is a farmers' cooperative organized as a cooperative corporation under State A law and is a farmers' cooperative under section 521 of the Code. Taxpayer is a marketing cooperative serving farmers producing _____ farm products – principally b, c, _____ and _____ crops.

During 2008, Taxpayer's sales were approximately \$ _____, and it now markets _____ food products for approximately _____ farmer members.

Taxpayer defines its mission in the following terms:

"The purpose of our co-op, [Coop], is to create and operate a marketing cooperative which promotes regional farm diversity and economic stability by means of _____ agricultural methods and the sale of _____ products.

Cooperatively market the finest in _____ products produced exclusively by our family of farmers.

Market nutritious, wholesome food as directly as possible to our customers.

Encourage a farming future that emphasizes ecological diversity and economic sustainability.

Enable a healthy human livelihood by providing quality employment, cooperation, _____ education, and community growth.

Practice environmental awareness and cooperative principles in all aspects of production, handling marketing and operations.

Promote a respect for the dignity and interdependence of human animal plant, soil and global life." (From Taxpayer's _____ Annual Report).

Taxpayer operates using separate pools for the principal _____ products it markets for its members. Taxpayer's b pool is by far its largest, accounting for _____ percent of _____ sales. Next largest is Taxpayer's c pool, accounting for _____ percent of _____ sales. Taxpayer's remaining pools –

_____ crops – together account for the remaining _____ percent of sales.

Taxpayer sells some of its members' _____ band crops in bulk form without processing. However, Taxpayer's focus is on processing of its members' _____ farm products into value-added products, e.g., _____ b, _____, _____, _____ products, _____ and _____ manufacturing ingredients, and then marketing the resulting food products. Most of the processing is outsourced to third parties, occurring under the supervision of Taxpayer and in accordance with the specifications established by Taxpayer.

Taxpayer currently markets over [redacted] different products manufactured in over [redacted] contracted manufacturing plants and [redacted] plants owned and operated by Taxpayer. Taxpayer's sales team promotes and sells the products across the United States. Over half of Taxpayer's sales are of products bearing Taxpayer's

[redacted] label and [redacted] label. Taxpayer also makes sales of products bearing private labels and sales of unbranded products (e.g., ingredients to be used by food manufacturers in their own products).

Taxpayer is organized and operated on a cooperative basis. As a marketing cooperative, it accounts for its earnings on the basis of pools for each of the principal [redacted] farm products it markets for its members. It currently has [redacted] pools – b, c, [redacted], and [redacted] crops. Farmer members of Taxpayer participate in one or more of its pools.

Prior to the beginning of the year, Taxpayer establishes the amount that it will pay to its members for their [redacted] b and other [redacted] products for the upcoming year. Taxpayer refers to this amount as the "pay price." It pays that amount to members at the time of delivery (or soon after delivery) throughout the year. In this ruling, payments to members of the pay price for their [redacted] b are referred to as "b checks" and payments to members of the pay price for other [redacted] farm products (including [redacted]) are referred to generically as "crop payments."

After the end of the year, Taxpayer determines its net earnings for the year. If a profitability target is met, a portion of Taxpayer's net earnings in excess of the target is contributed to Taxpayer's section 401(k) plan for employees and a portion is contributed to community charities. Then, after setting aside an amount for dividends and an amount for reasonable reserves, all remaining net earnings are paid to members as patronage dividends.

The focus of this ruling is on the amounts paid to members and nonmember patrons for their [redacted] b and crops in the form of b checks and crop payments. Taxpayer is asking for confirmation that such payments qualify as per-unit retain allocations paid in money as that term is used in section 1382(b)(3) of the Code. Taxpayer is also asking for confirmation that, for purposes of computing its section 199 domestic production deduction, Taxpayer's qualified production activities income (QPAI) and taxable income should, pursuant to section 199(d)(3)(C), be computed without regard to any deduction for such payments.

Taxpayer is organized as a cooperative corporation pursuant to the State A Cooperative Association Act (Chapter [redacted] of the State A Statutes) (the Act). As is typical for state cooperative statutes, Section [redacted] of the Act authorizes cooperative associations organized under the Act to enter into marketing contracts with members in which the members agree to "sell, market or deliver all or any specified part of products

produced or to be produced either by the member or under the member's control to or through the association or any facilities furnished by it." Taxpayer enters into contracts with its members that obligate them to sell their crops to Taxpayer and obligate Taxpayer to pay them for their crops in accordance with its pay programs.

Section of the Act provides rules for the "apportionment and distribution of proceeds" by associations organized under the Act. It begins by directing that "at least once annually the directors shall determine and distribute the net proceeds" of the association in the manner described in the section.

For this purpose, amounts paid to members of a cooperative for their products are treated as a deduction in arriving at net proceeds. Section of the Act defines "net proceeds" as the total proceeds less:

- "(a) All operating expenses and costs.
- (b) The cost of supplies, commodities, equipment and other property or services procured or sold for patrons.
- (c) The cost of services performed for patrons.
- (d) All taxes and all other expenses.
- (e) Reasonable and necessary reserves for depreciation, depletion and obsolescence of physical property, doubtful accounts and other valuation reserves, all of which shall be established in accordance with usual and customary accounting practices." (emphasis added).

Section of the Act provides that net proceeds may be used (i) to pay dividends on capital stock as authorized in the association's articles of incorporation, (ii) to pay compensation to officers or employees (or both), and (iii) to provide for an educational fund to be used for teaching or promoting cooperative organization or principles.

Section of the Act provides that unless the association's articles of incorporation or bylaws "otherwise expressly provide, none of the remainder of the net proceeds shall constitute income of the cooperative...." The remainder shall be distributed and paid to patrons, whether members or not, as follows:

- "(a) Reasonable reserves for necessary purposes may be created, which shall be credited to patrons in accordance with the ratio which their patronage bears to total patronage.

(b) All the remainder of the net proceeds shall be distributed and paid to patrons in accordance with the ratio which their patronage bears to total patronage.

(c) There shall be no distinction between the persons entitled thereto, but such reserves and distributions may be based upon business done with particular departments or in particular commodities, supplies or services, or upon classification of business according to the type or nature thereof.”

Section _____ of the Act provides that the distribution to patrons may be made in cash, property, a broad range of written notices of allocation, or in any combination thereof.

Taxpayer’s Third Amended and Restated Articles of Incorporation (Articles of Incorporation) provide that “the business and activities of this corporation shall be conducted on a cooperative basis....” Article II, Section 2.1(a). They state that Taxpayer is organized “to create a marketing cooperative which promotes regional farm diversity and economic stability by means of _____ agricultural methods and the sale of _____ products.” Article II, Section 2.1(a).

Taxpayer is organized on a stock basis. It has _____ classes of stock. Class A Stock is membership stock. Only members may own Class A Stock. In order to eligible for membership, a person must be a producer of agricultural products or an association of such producers. Article IV, Section 4.2(a). Class A Stock is the only class of stock with voting rights. Because each member of Taxpayer owns one share (and only one share) of Class A Stock, Taxpayer is organized on a one-member, one-vote basis. Article IV, Section 4.2(a). New members pay \$ _____ for a share of Class A Stock. No dividends are paid on shares of Class A Stock. Article IV, Section 4.2(b). On liquidation, holders of Class A Stock have a fourth preference to receive an amount equal to the consideration for which the stock was issued (i.e., \$ _____) and no more. Article VI.

If a person ceases to be eligible to own Class A Stock, Taxpayer has the right to redeem the person’s share of Class A Stock for the consideration the member paid for the share or to convert the share into a nonvoting certificate of interest or other nonvoting equity. Article IV, Section 4.6. Taxpayer regularly reviews its stock ownership rolls for Class A Stock and terminates members who have failed to patronize Taxpayer for a period of one year or more to assure compliance with the “substantially all” test of section 521(b)(2) of the Code.

The remaining classes of stock _____
)) do not have membership voting rights. Each class has dividend rights (not to exceed _____ percent per annum) as specified in the Articles of Incorporation. Article

IV. On liquidation, each class has a liquidation preference specified in the Articles of Incorporation to receive an amount equal to the “par value of such shares or book value, whichever is lower, plus any unpaid dividends declared thereon” and no more. Article VI.

The _____) classes of stock are designed for different purposes. Taxpayer has a Base Capital Plan which generally requires members to purchase stock in Taxpayer in an amount equal to _____ percent of their annual base gross income from sales through Taxpayer. _____ Stock is used for this purpose. _____) is used for the noncash portion of patronage dividends. Class _____) are investment stock, which is sold to

Taxpayer markets only products raised by members and other producers (as that term is used in section 521(b)(1) of the Code). Almost all (_____ percent) of the products that Taxpayer markets are raised by member producers. Producers of agricultural products who patronize Taxpayer, but are not eligible to be a member and Class A stockholder, “may nevertheless conduct business with [Taxpayer] on a patronage basis as a nonmember patron....” Article IV, Section 4.7. Business with nonmember producers (who are entitled to share in patronage dividends) accounts for the remaining _____ percent of the products that Taxpayer markets. As required by section 521(b)(1), Taxpayer treats nonmember patrons in the same manner as member patrons, except that nonmember patrons do not have voting rights. Because Taxpayer deals with nonmember patrons on a patronage basis, the b checks and crop payments that are the subject of this ruling request include both amounts paid to members and amounts paid to nonmember patrons.

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

“The net income of this cooperative in excess of dividends on equity capital and additions to reserves shall be distributed to members and nonmember patrons annually or more often on the basis of patronage and the records of this cooperative may show the interest of members and nonmember patrons in the reserve. Net income may be accounted for and distributed on the basis of allocation units that may be functional, divisional, departmental, geographic, or otherwise. Net income may be distributed in cash, capital stock credits, allocated patronage equities, revolving fund certificates, securities of this cooperative, other securities, or any combination thereof. ... The foregoing provisions of this Article shall be implemented as more particularly provided in the Bylaws of this cooperative.”

Article VII of Taxpayer's By-laws provides a detailed description of the determination and distribution of its net earnings. Section 7.02 of the By-laws begins with a general description of how Taxpayer operates on a cooperative basis:

“ . . . This cooperative shall be operated upon the cooperative basis in carrying out its business within the scope of the powers and purposes defined in the Articles of Incorporation. Accordingly, the net income of this cooperative in excess of amounts credited by the Board of Directors to capital reserves and the amounts of dividends, if any, paid with respect to equity capital shall be accounted for and distributed annually on the basis of allocation units (as authorized by the Board of Directors) as provided in this bylaw.”

Section 7.04 of the By-laws authorizes the Board of Directors to establish allocation units “on a reasonable and equitable basis” for use in allocating patronage income. Section 7.01 of the By-laws provides that “[e]ach distinct pool of [Taxpayer] is an allocation unit. . . .” As described above, Taxpayer has established the commodity pools.

Section 7.05 of the By-laws provides for the determination of the patronage net income or loss of each allocation unit or pool. The determination begins by identifying the revenues of each unit. Then, the various specified items (including b checks and crop payments) are subtracted in determining patronage net income or loss of the pool:

“ . . . less (3) all expenses and costs of goods or services directly attributable to goods or services marketed or procured for patrons of the allocation unit, less (4) an equitably apportioned share of all other expenses or losses attributable to this cooperative's patronage business, dividends on equity capital and distributable net income from patronage business that is credited to the Capital Reserve pursuant to Section 7.09.” (emphasis added).

Section 7.06 of the By-laws then provides that the “net income of an allocation unit from patronage business for each fiscal year . . . shall be allocated among the patrons of the allocation unit in the ratio that the quantity or value of the business done with or for such patron bears to the quantity or value of the business done with or for all patrons of the allocation unit.” Section 7.08 of the By-laws provides that amounts so allocated shall be distributed to patrons as a patronage refund.

This ruling relates to the status of payments made by Taxpayer to members and nonmember patrons for the crops that are marketed on a cooperative basis. Taxpayer's most significant activity is marketing b and b products through the b pool. Each farmer that is a member of the b pool enters into a Taxpayer

Cooperative b Member Agreement. That agreement outlines the terms and conditions under which Taxpayer will purchase and market b produced by the farmer.

In Section 2 of the membership agreement, the farmer: “pledges all b production to the Cooperative, and assigns all rights to proceeds from sales of the b products.” The assignment of proceeds language is included in the agreement to prevent members from selling their b to others in violation of the member agreement. The Act provides that, if a cooperative contract contains such language, “any person who accepts or receives such product from the member is bound by such assignment after receiving written notice from the association or the member of the amount and duration of this assignment.” Section of the Act. Thus, this language is intended to provide Taxpayer the remedy provided by State A law if a member attempts to deliver his products to someone else in violation of his or her pledge of all b production to Taxpayer during the term of the agreement.

Section 2 of the agreement goes on to provide that: “[t]he Member hereby appoints the Cooperative as its exclusive agent in the marketing of b products.” This language is intended to make it clear that, where a member is a member of both Taxpayer and another b marketing cooperative (which is often the case), the member’s b will be delivered and sold to Taxpayer, not the other cooperative. While this language styles Taxpayer as an “agent” of its members, the member agreement is intended to effect a sale of their b to Taxpayer, and it is treated in that manner by Taxpayer and its members for tax and accounting purposes. Once b has been delivered to Taxpayer, it becomes the property of Taxpayer (and the risks and benefits and burdens of ownership pass to Taxpayer). Taxpayer commingles the b with b of other members. The processing and marketing of the b are under the exclusive control of Taxpayer. The relationship of the member and Taxpayer is the relationship of a member of a cooperative and the cooperative, not the relationship of principal and agent.

Taxpayer’s members are located across the United States and Taxpayer has relationships with b handlers (including other cooperatives) located across the country who receive, assist in testing, and pay for Taxpayer’s members’ b on Taxpayer’s behalf. The handlers pay Taxpayer members the agreed Taxpayer pay price for their b with funds supplied by Taxpayer and dispose of the b in accordance with Taxpayer’s instructions. Taxpayer regards the handlers as its agents and treats the deliveries as sales by the member to Taxpayer.

With respect to payment to members for b, the membership agreement provides: “[t]he Cooperative will pay the Member for their [b] according to the rates and programs established by the [b] Executive Committee and the Board of Directors for the Member’s region.”

Each year, before the beginning of the year, Taxpayer goes through a budgeting process for the upcoming year, and establishes a pay program for the b pool. The

intent is to establish a fixed price which will be used by the b pool to make an advance to each member and nonmember patron at the time of delivery that will approximate budgeted net proceed for the year for the pool less a cushion. Taxpayer's philosophy is to pay the maximum pay price to its members and nonmember patrons consistent with prudent business operation.

In spite of the volatility of commodity prices, Taxpayer is able to set the pay price for b a year in advance because many of its customers are willing to make long-term fixed price purchase commitments to Taxpayer for the b and the b products. Taxpayer occasionally finds it necessary to adjust the pay price for a pool during the course of a year either up or down to reflect developments affecting the projected profitability of the pool. However, it seeks to limit the occasions when this is done.

For some pools, like the b pool, that include farmers located across the country, Taxpayer sets a base price on a national level and then pays regional premiums, in an effort to fairly allocate the proceeds of the pool among members. For this purpose, Taxpayer currently has divided the b pool into regions. This pay price for the b pool and the regional premiums are established by Taxpayer's Board of Directors, all of whom are farmer members of Taxpayer.

Each region starts with the same base price. That price is based upon the components of the b being delivered. To that price is added a regional premium. When a farmer delivers his or her b, the b is weighed and tested. The b components are measured, and the price is determined based upon the component price. Adjustments (up or down) are made for other measures of quality. The standards for those adjustments are set forth in the pay price schedules. The same standards are used in all geographic regions. In addition, there is an adjustment to the pay price for months when b production is highest and lowest.

It is Taxpayer's intention that the announced pay price each year will remain in place for the entire year without change. That way the return to be enjoyed by farmers is predictable, and farmers can plan accordingly.

As a result of the approach taken to pooling, all members in a region receive a uniform pay price for the b they deliver to Taxpayer. While the determination of the pay price for b by Taxpayer does not follow the approach taken by cooperatives marketing b, Taxpayer (or the handlers making payments on Taxpayer's behalf) follow the rules of the Federal and b Market Orders and make semi-monthly payments to members. All payments are in cash by check.

As is common in the b industry, Taxpayer treats its b pool (and its other pools) as closing at the end of each year. In the member agreement, each member agrees "to be bound by both Cooperative bylaws and this agreement." Section 1. As described above, the By-laws detail how Taxpayer accounts for the net earnings of each pool

(determined after deducting b checks and other crop payments) and pays patronage dividends. After the close of each year, the actual earnings of the pool are determined. After providing for dividends and reserves, any remaining earnings are distributed on a patronage basis as described above. For the b pool, distributions are based upon hundredweights of b marketed through Taxpayer (without regard to region).

Members of the c pool enter into a c Pool Member Agreement. This agreement is almost identical to the form of member agreement used in the b pool. The c pool was founded in _____ and is focused on the production of _____ produced _____ c. Like the b pool, the c pool is divided into _____ regions – _____ . Each region has its own pay price schedule.

The _____ c Farmer Pay Price schedule explains Taxpayer’s “pay price principle:”

“The [Taxpayer] Producers have elected to have a stable Pay Price not connected to the conventional pay price. The [Taxpayer] Producers, through the [c] Pool and the [c] Executive Committee, have determined this pay structure because they feel it is fairest to all producers and reflective of the performance of the business. The Cooperative makes all efforts to meet the established budget base price, however, the price can be adjusted by the Board of Directors and the [c] Executive Committee if the actual financial performance of the co-op requires it.”

The schedule then specifies the amount paid for c. For certain kinds of c, the price paid is the conventional market value because these c must be sold in conventional markets.

Members are paid in cash for their c on a semi-monthly basis. Members in each region are treated in the same manner. After the close of the year, the profitability of the pool is determined and accounted for in the same manner as for the b pool.

Taxpayer’s other pools (_____) operate in much the same manner as the b pool and the c pool. A pay price is determined prior to the beginning of each year for each of these pools in the same manner that the pay price is determined for the b pool and the c pool. Members and nonmember patrons are paid that price on a semi-monthly or monthly basis in cash by check. After the close of the year, the profitability of the pool is determined and accounted for in the same manner as for the b pool and c pool.

Operating in the manner described above, Taxpayer made payments in excess of \$ _____ to members and nonmember patrons during _____ in the form of b checks and crop payments for their _____ b and crops.

Taxpayer has treated b checks and crop payments as “purchases” for tax purposes and reported them on Schedule A, Line 2 of its Form 1120-C. Taxpayer has not reported b checks and crop payments 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 patronage dividends paid to 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 checks and crop payments have entered into the determination of Taxpayer’s cost of goods sold for tax purposes. Taxpayer values its inventories at year end at the lower of cost or market for financial statement and for tax purposes.

Taxpayer has done a section 199 computation in prior years. In that computation it has not added-back b checks and crop payments. Taxpayer has not passed through any portion of its section 199 deduction to members in prior years.

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 section 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) of the Code 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 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, section 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, section 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.

Taxpayer is a “specified agricultural or horticultural cooperative” within the meaning of section 199(d)(3)(F) of the Code and section 1.199-6(f) of the regulations. Taxpayer is an organization “to which Part I of subchapter T applies.” It is engaged in

the marketing of agricultural or horticultural products (i.e., crops and products made from the crops of its members).

As a specified agricultural or horticultural cooperative, Taxpayer is entitled to the benefit of section 199(d)(3)(C) of the Code and section 1.199-6(c) of the regulations which permit such cooperatives to disregard deductions under section 1382(b) and (c) for purposes of computing QPAI 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.

Farmers marketing their b and other products through Taxpayer are entitled to receive b checks and other crop payments during the course of each year in accordance with Taxpayer's pay price programs. In addition, provided that Taxpayer is profitable and has net earnings in excess of those required to pay dividends on its stock and to provide for reasonable reserves, they are entitled to receive a patronage dividend after year end.

Taxpayer's b checks and other crop payments meet the definition of "per-unit retain allocations paid in money" which are excludible or deductible under section 1382(b)(3) of the Code. The b checks and crop payments are made in cash by check so the "paid in money" requirement is met. Taxpayer's b checks and crop payments also meet all the requirements of the definition of "per-unit retain allocation" contained in section 1388(f), 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, Taxpayer's b checks and other crop payments are paid to farmer members pursuant to the Act, Taxpayer's Articles of Incorporation and Bylaws, and Taxpayer's membership agreement and pay price programs, and thus the "pursuant to an agreement" requirement is met.

Second, Taxpayer's b checks and crop payments to a member are made "with respect to products marketed for him," namely, the b, c, crops and delivered by the member for marketing by Taxpayer.

Third, the amount of the b checks and crop payments to each member "is fixed without reference to the net earnings" of Taxpayer since, at the time the payments are made, Taxpayer's actual net earnings for the year are neither known nor determinable. At the time the pay price programs are announced and the actual payments are made,

while projections or estimates of Taxpayer's net earnings for the year may be made, Taxpayer's actual net earnings for the year are not known or determinable. When Taxpayer's net earnings are determined after the end of the year, if Taxpayer is sufficiently profitable, farmer members are entitled to an additional distribution out of Taxpayer net earnings from business done with or for patrons as described above. This additional distribution is determined based upon Taxpayer's net earnings and is treated as a patronage dividend, not as a per-unit retain allocation.

Thus, Taxpayer's b checks and other crop payments meet all the requirements specified in subchapter T of the Code for per-unit retain allocations. Because all payments are in cash or by check, they qualify as per-unit retain allocations paid in money.

Taxpayer represents that it has not reported its b checks and other crop payments in the manner that pooling cooperatives normally do. It has treated them as "purchases," not as "per-unit retain allocations paid in money or certificates." That does not mean that Taxpayer should be treated as a nonpooling cooperative.

Because of the manner in which Taxpayer operates, Taxpayer does not need to rely on the presumption of section 1382(e)(2) of the Code that the "marketing of products [under a pooling arrangement] shall be treated as occurring during any of the taxable years in which the pool is open." It is clear under section 199 and section 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.

The effect of these sections is that a cooperative such as Taxpayer 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 section 199(d)(3) of the Code and the regulations thereunder.

For reasons described above, Taxpayer's b checks and crop payments meet the definition of "per-unit retain allocations paid in money." Thus, Taxpayer is entitled to disregard such payments in determining the amount of its section 199 deduction.

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

1. Taxpayer's b checks and crop payments to members and nonmember patrons for their b and other crops 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 such b checks and crop payments.

No opinion is expressed or implied regarding the application of any other provision in the Code or regulations.

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)