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Date:
October 01, 2009

LEGEND:

Taxpayer =

State A =

Dear _____:

This is in response to a request for rulings dated April 24, 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 under the State A Cooperative Law. Taxpayer operates as a grain marketing and agricultural supply cooperative. Taxpayer also provides its members with a variety of services. The members of Taxpayer include approximately _____ local farm supply and grain marketing cooperatives and over _____ farmers and ranchers.

Taxpayer sells a broad range of farm supplies – including energy products (such as diesel fuel, propane, heating oil, and gasoline), crop nutrients, and livestock feed – to its local farm supply cooperative members, which they in turn sell to their farmer and rancher members. Taxpayer also sells farm supplies directly to farmer and rancher members.

In addition, Taxpayer markets grain for its farmer and local grain marketing cooperative members. The principal grains marketed include _____ and _____. Taxpayer also markets _____ and _____. Some of the grain Taxpayer markets is processed by Taxpayer and joint

ventures in which Taxpayer participates and sold in the form of value-added food, food ingredients and other grain products.

The State A Cooperative Law applies to organizations “formed or incorporated on a cooperative plan” for a variety of purposes including for the purpose of conducting an “agricultural, dairy, [or] marketing ... business.” The State A Cooperative Law requires that a cooperative distribute “[n]et income in excess of dividends on capital stock and additions to reserves ... on the basis of patronage.” The statute provides that the distribution shall be made “at least annually.” The distribution may be “in cash, capital stock credits, allocated patronage equities, revolving fund certificates, or its own or other securities.”

Taxpayer’s Articles of Incorporation provide that “the business and activities of this cooperative shall be conducted on a cooperative basis, as provided in the Bylaws of this cooperative.” Article II, Section 1. Article V provides:

“The net income of this cooperative in excess of 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 equity holders in the reserves. 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, allocated patronage equities (including without limitation Patrons’ Equities), revolving fund certificates, securities of this cooperative, other securities, or any combination thereof. Any such allocated equity shall be redeemable only at the option of the Board of Directors. The net loss of an allocation unit or allocation units may be offset against the net income of other allocation units to the extent permitted by [State A] Statutes Section

The net income or loss of this cooperative or any allocation unit may be determined by including the cooperative’s proportionate share of the net income or loss of other entities in which the cooperative owns an equity interest. The foregoing provisions of this Article V shall be implemented as more particularly provided in the Bylaws of this cooperative.”

The Articles of Incorporation provide that Taxpayer “is organized without capital stock on a membership basis.” Article IV, Section 1. The Articles limit membership in Taxpayer to “associations of agricultural producers of agricultural products which are organized and operating so as to adhere to the provisions of the Agricultural Marketing Act ... and the Capper Volstead Act ... and to certain producers of agricultural products...” Article IV, Section 2. Taxpayer currently has two classes of members – Cooperative Association Members and Individual Members (for purposes of this ruling, Taxpayer’s members are referred to as “members”). Article IV, Section 3. The Articles of Incorporation provide that patronage may be paid to persons, not eligible to be

members of Taxpayer, to the extent provided for in the Bylaws. Article IV, Section 5. Such persons (i.e., nonmembers entitled to share in patronage dividends) are referred to by Taxpayer as “nonmember patrons.” Article IV, Section 5. For purposes of this ruling, nonmembers who are entitled to share in patronage dividends will be referred to as “eligible nonmember patrons” (to more clearly distinguish them from nonmembers not entitled to share in patronage dividends) and other nonmembers will simply be referred to as “nonmembers.”

Taxpayer’s Articles of Incorporation provide that, upon dissolution, any residual assets (those remaining after debts have been paid and holders of equity capital and allocated equities have been paid their stated dollar amount) “shall be paid to the patrons of this cooperative on the basis of their past patronage.” Article VII, Section 1.

Article VII of Taxpayer’s Bylaws provides a detailed description of how Taxpayer computes and pays patronage refunds. Section 1 of Article VII of Taxpayer’s Bylaws provides that:

“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 shall be accounted for and distributed annually on the basis of allocation units as provided in this Article VII.”

That section goes on to create a presumption that all business Taxpayer does with members will be done on a patronage basis unless “such member and this cooperative have expressly agreed to conduct said business on a nonpatronage basis.” It also creates a presumption that all business Taxpayer does with nonmembers will be conducted on a nonpatronage basis “unless this cooperative agrees to conduct said business on a patronage basis.”

While authorized to conduct business with nonmembers on a patronage basis, Taxpayer generally conducts business with nonmembers on a nonpatronage basis. At present, the only nonmembers treated as eligible nonmember patrons are limited liability companies that are at least percent owned by persons who are otherwise members of Taxpayer. Less than percent of Taxpayer’s overall business is conducted with eligible nonmember patrons.

Sections 3 and 4 of Article VII of the Bylaws provide for the establishment of allocation units and the determination of the patronage net income or loss of an allocation unit. In determining the patronage net income or loss, Section 4 provides that the gross revenues of the unit attributable to patronage business shall be determined and then all expenses and costs of goods or services attributable to the unit shall be subtracted. In determining net income of its grain allocation units, grain payments (as described below) are subtracted.

Section 5 of Article VII of the Bylaws provides that:

“The net income of an allocation unit from patronage business for each fiscal year, less any amounts thereof that are otherwise allocated in dissolution pursuant to Article IX, shall be allocated among the patrons of such allocation unit in the ratio that the quantity or value of the business done with or for each such patron bears to the quantity or value of the business done with or for all patrons of such allocation unit. The Board of Directors shall reasonably and equitably determine whether allocations within any allocation unit shall be made on the basis of quantity or value.”

Section 6 of Article VII of the Bylaws describes what may be done in the event an allocation unit incurs a net loss in any fiscal year from patronage business, including charging the loss to the patrons of the unit by “establish[ing] accounts payable by patrons of the allocation unit that incurs the net loss that may be satisfied out of any future amounts that may become payable by this cooperative to each such patron” or “[c]ancel[ling] outstanding Patrons’ Equities.” The section goes on to provide that any amounts so allocated to patrons “shall be made among the patrons of an allocation unit in a manner consistent with the allocation of net income of such allocation unit.”

This ruling relates to Taxpayer’s grain marketing activities. Taxpayer markets grain on a patronage basis for its members, which include both farmer producers and local grain cooperatives, and for eligible nonmember patrons.

Through its county operations business, Taxpayer operates a number of local grain elevators which purchase grain from farmer producers. Through its grain marketing business, Taxpayer markets that grain (other than grain sold locally) and grain from its local cooperative members to domestic and foreign millers, maltsters, feeders, crushers and other processors. Taxpayer also sells grain to intermediaries and distributors.

During the fiscal year ended _____, Taxpayer marketed almost _____ bushels of grain. Taxpayer processes some of its grain it purchases into value-added products, including food products. Taxpayer’s value-added processing operations are varied. Taxpayer is a _____ percent owner of a venture that takes some of these products and further processes them into food products, which the venture then sells. The patronage-sourced earnings from Taxpayer’s value-added activities are included in the net earnings distributed to its members and eligible nonmember patrons as patronage dividends.

Taxpayer’s grain business on behalf of its members and eligible nonmember patrons consists of buying grain from members and eligible nonmember patrons, handling and storing the grain at its elevators, processing some of the grain (either itself or through joint ventures) and selling the resulting products, and selling the remainder of the grain to grain processors, feed lots, grain exporters and others.

The issue in this ruling relates to the characterization, for purposes of subchapter T of the Code and section 199, of payments that Taxpayer makes to its members and to eligible nonmember patrons when it acquires their grain for marketing on a patronage basis. The payments that are the subject to this ruling (referred to as “grain payments”) are amounts paid to members and eligible nonmember patrons for their grain. Taxpayer makes grain payments to two categories of members: (i) farmer members who sell grain to Taxpayer (typically for delivery to Taxpayer’s country elevators, river terminal elevators or to other locations at Taxpayer’s direction) for marketing on a patronage basis and (ii) local cooperative association members who sell grain to Taxpayer (typically for delivery to Taxpayer’s export and river terminals or to other locations at Taxpayer’s direction) for marketing on a patronage basis.

The term “grain payments” does not include any amounts that Taxpayer pays to persons who are nonmembers (and not eligible to share in patronage dividends) for grain. Also, the term “grain payments” does not include patronage dividends paid to members and eligible nonmember patrons of Taxpayer with respect to grain marketed for them.

Taxpayer purchases grain from farmer producers for delivery to its country grain elevators, and, to some extent, to its terminal elevators or other locations at its direction. Taxpayer’s country grain elevator operations are similar to those conducted by local grain marketing cooperatives. In fact, many of the elevators were operated by local cooperatives before being acquired by Taxpayer through merger or purchase. Some of the grain from Taxpayer’s country grain elevators is marketed locally for feed and processing, but most is marketed (along with the grain from Taxpayer’s local grain cooperative members and others) through Taxpayer’s core grain marketing operations.

Taxpayer also purchases some grain from producer members for delivery at river terminals or other locations at Taxpayer’s direction. Such purchases typically occur where a producer is located close to one of the terminals or other locations and it is more economical for the farmer to deliver the grain directly to the terminal than to a country elevator operated by Taxpayer or one of Taxpayer’s local cooperative members.

Taxpayer does not operate on a pooling basis. Thus, the members of Taxpayer do not commit to deliver all of the grain they grow from specified acreage to Taxpayer to be pooled with the grain of other members as would be the case if Taxpayer operated like a pooling cooperative. Commodity price risk does not shift from Taxpayer’s members to a pool at the time of harvest, but rather remains with Taxpayer’s members until they decide to sell their grain to Taxpayer for marketing. All of Taxpayer’s marketing proceeds are not shared equally on the basis of patronage and distributed in the form of harvest advances and progress payments with a final settlement after the pool closes as they would be if Taxpayer pooled. Rather, Taxpayer pays each farmer member a market price for his or her grain. That market price is determined without regard to the actual net proceeds from marketing grain.

What that market price is depends upon where, when and how the farmer member chooses to sell his or her grain to Taxpayer. The basic options available to farmers are described below. Payments are made in cash (by check) and occur throughout the year as members sell grain to Taxpayer for marketing on a patronage basis and are paid pursuant to the terms of their grain contracts.

After purchasing grain from its members, Taxpayer then markets each member's grain along with the grain of all of its members in the manner that it judges will produce the best return. After year end each year, when net earnings for the year have been determined (subtracting grain payments in this determination), Taxpayer pays a patronage dividend to its farmer members and eligible nonmember patrons with respect to the grain they market through Taxpayer.

Farmers historically have retained the decision of when and how to sell the grain that they raise, either to a cooperative for marketing on a patronage basis or to a commercial grain company. Taxpayer offers farmers a variety of alternatives when they sell their grain to Taxpayer. The choices are similar to those offered farmers by commercial grain companies, though, of course, commercial grain companies do not market grain on a patronage basis and do not pay patronage dividends.

The basic choices available to a farmer selling grain to Taxpayer for marketing on a cooperative basis are: (i) to simply sell the grain for the current cash bid price of Taxpayer elevator buying the grain, (ii) to sell the grain to Taxpayer elevator using a forward contract, and (iii) to sell the grain to Taxpayer elevator using a deferred price contract. Under each of these basic choices, there are additional options available to farmers.

One way for a farmer to sell grain to Taxpayer for marketing on a patronage basis is to simply sell the grain to Taxpayer at one of Taxpayer's country elevators (or to a terminal elevator or processing facility) and be paid the elevator's cash bid price. Typically a country elevator's cash bid price for a commodity at any time is the nearby futures price in a specified reference market where the commodity is actively traded (e.g., the Chicago Board of Trade or the Minneapolis Grain Exchange) plus or minus a fixed spread (referred to as the "basis") set from time to time by the elevator based upon local market conditions. Thus, the cash bid price at any time at any country elevator reflects the condition of the overall market for grain (the futures price) and the condition of the local market for grain (the basis). An elevator's cash bid price changes during the course of each day as the reference futures price fluctuates. It also changes as the elevator adjusts the basis.

Farmers can deliver and sell grain to Taxpayer country elevators at the cash bid price at the time of harvest, delivering the grain directly from their fields. However, it usually is not advantageous for farmers to sell then since prices often are lowest at harvest.

Many farmers have the capacity to store grain on their farm and so can wait until later, when they think that the cash bid price is right, to deliver and sell their grain to Taxpayer. Other farmers deliver grain to a Taxpayer country elevator for storage, not for immediate sale. The farmers retain ownership of the grain in the elevator and pay storage fees to Taxpayer. Later, when a farmer believes the cash bid price is right, he or she can sell the grain to Taxpayer for marketing on a cooperative basis.

A farmer has the option of entering into a forward contract to sell his or her grain to Taxpayer. Forward contracts call for delivery of a specified quantity and quality of grain, at a specified location, during a specified time period. Forward contracts can be entered into before the grain is planted, while it is growing or after harvest while the grain is being stored on the farm or in an elevator.

Forward contracts can be priced in a variety of ways. Many contracts provide for a fixed price, referred to as a "flat" price. Farmers interested in entering into a forward contract with Taxpayer can determine the flat price Taxpayer is willing to pay at any time at any of its locations for delivery at various times in the future from Taxpayer's bid schedules for grain for future delivery.

Typically a country elevator's bid price for future delivery is determined in a manner similar to the way the cash bid price is determined. However, when the bid price is for future delivery, it is based upon the nearby futures price for the time specified for delivery plus or minus the basis set by the country elevator for that delivery month. The bid price for future delivery changes during the course of each day as the specified reference price fluctuates. It also changes as the country elevator adjusts its basis.

Farmers also can enter into forward contracts where the pricing is left open for future determination. For instance, the contracts may fix the basis and leave the futures price open, to be determined based upon the futures price at the time chosen by the farmer before a specified date in the future. Alternatively, the contracts may specify the futures price and leave the basis open, to be determined based upon the elevator's basis for delivery during the future month at the time chosen by the farmer before a specified date in the future. Some contracts specify a minimum price that will be paid for the member's grain, giving the farmer the option to fix the price before a specified date in the future based upon a reference futures price, leaving open the possibility that a price greater than the minimum price will be paid if futures prices go up.

Farmers have the option to deliver grain to Taxpayer, leaving the determination of the price partly or wholly open. Contracts of this sort are called by various names – deferred price contracts, delayed price contracts, credit-sale contracts, etc. Under a deferred price contract, ownership of the grain passes from the farmer to Taxpayer at the time of delivery. Farmers are given the opportunity to wait until later to price the grain. When the farmer chooses to price the contract, the cooperative's then current bid

price is used to fill the open price term. Once the price is determined the farmer member is paid.

The variety of options available to farmers for selling their grain to Taxpayer and other grain companies provide farmers with a great deal of flexibility. Farmers can lock in prices for their crops (even before they are planted or while they are growing) at any time if they think that the price is right by using flat price forward contracts. Some farmers prefer to do so after they can estimate the costs of production to lock in a reasonable margin. If farmers think that the cash price is low at the time of harvest, they can harvest and store their crops while waiting for the price to improve. Alternatively, they can deliver the crops and enter into a deferred price contract. If a farmer is happy with the futures price, but not the basis, the farmer can enter into a deferred price contract that leaves the basis open. If a farmer is happy with the basis, but not the futures price, the farmer can enter into a deferred price contract that leaves the futures price open. If a farmer wants the assurance of a minimum price, the farmer can enter into a contract that specifies a minimum price, but leaves final pricing open. Such a contract can result in a higher price if the futures price increases, or a guaranteed minimum price (albeit somewhat lower than the farmer could otherwise have obtained) if the futures price does not increase.

These choices are available to all farmers marketing their grain on a cooperative basis through Taxpayer. Because of these choices, two neighboring farmers that market the same quantity and quality of a particular kind of grain through Taxpayer during any year will receive different grain payments depending upon where, when and how they sell their grain to Taxpayer. However, they will receive the same patronage dividends.

Taxpayer's grain marketing business was originally organized to market grain for local cooperative elevators. That business remains the core of its grain marketing operations. Today the grain marketing division markets grain from Taxpayer's local cooperative members, from Taxpayer's country elevators, from Taxpayer farmer members located close to its elevators and terminals, and from other sources (nonmembers).

During its fiscal year ended _____, Taxpayer marketed almost _____ bushels of grain (including oilseed). Approximately _____ percent of the volume of the grain and oilseed marketed was marketed for the farmer and local cooperative association members and for eligible nonmember patrons of Taxpayer. The remainder was purchased from nonmembers (i.e., from persons not entitled to share in patronage dividends).

Local cooperative association members are not contractually obligated to market grain through Taxpayer. It is up to them to determine whether and when to sell grain to Taxpayer for marketing on a patronage basis. Local cooperative association members typically sell their grain to Taxpayer for marketing on a patronage basis using a forward

contract similar to the forward contracts used by Taxpayer's country elevators when they contract to purchase grain from farmer members.

As in the case of the country elevator operations, there is no pooling. A local cooperative member delivering its grain to Taxpayer for marketing receives what the member and Taxpayer have agreed is the purchase price for the member's grain. If the grain marketing operations as a whole are profitable (after taking into account grain payments to all members), the member later receives a patronage dividend.

Because of the choices presented to all local cooperative members by the system of cooperative marketing of grain, two neighboring associations that market the same quantity and quality of a particular kind of grain through Taxpayer during any year will likely receive different grain payments depending upon where, when and how they sell their grain to Taxpayer, though they will receive the same patronage dividend.

For the fiscal year ended _____ Taxpayer made grain payments to farmer members and to local cooperative association members (and to eligible nonmember patrons) of approximately \$ _____. For the year, Taxpayer paid patronage dividends to members and eligible nonmember patrons with respect to their grain of approximately \$ _____. The patronage dividends were paid in cash and qualified written notices of allocation.

Taxpayer has treated grain payments made in cash to members as "purchases" for tax purposes and reported them on Schedule A, Line 2 of its Form 1120-C. Taxpayer has not reported the grain 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 grain members and eligible nonmember patrons as a patronage dividend paid in money and qualified written notices of allocation on Schedule H, line 3a of its Form 1120-C.

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

Taxpayer did not add back grain payments in its section 199 computations for prior years, but it did add back patronage dividends paid to members and eligible nonmember patrons. Taxpayer did not pass any portion of its section 199 deduction through to its members or eligible nonmember patrons in prior years.

Taxpayer is seeking confirmation that all grain payments to members and eligible nonmember patrons that are paid in cash should be classified as "per-unit retain allocations paid in money." Taxpayer plans to begin reporting grain payments in this manner.

In prior years, Taxpayer has disregarded patronage dividends paid in cash and qualified written notices of allocation for purposes of determining qualified production activities income and taxable income for section 199 purposes. Taxpayer plans to begin disregarding grain payments made to members and eligible nonmember patrons for purposes of computing its qualified production activities income and its taxable income.

Based on the foregoing Taxpayer request the following rulings:

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

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 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.

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., grain, which it markets, and various farm supplies, which it sells to 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.

Taxpayer does not operate on a pooling basis. Taxpayer purchases grain from its members and from eligible nonmember patrons and markets that grain. The amount that each member and each eligible nonmember patron receives when it sells grain to Taxpayer for marketing depends upon where, how and when the patron chooses to sell that grain to Taxpayer. Members are not required to deliver their grain to Taxpayer. They are free to sell as little or as much of their grain to Taxpayer as they choose.

Members and eligible nonmember patrons have a number of options for determining how and when sales are made. As a result, two neighboring farmers delivering the same amount of grain to Taxpayer during any year will be paid different amounts for that grain depending upon where, when and how they sell the grain to Taxpayer. However, all members and eligible nonmember patrons share in Taxpayer's net earnings from member grain operations in proportion to the number of bushels of grain they market through Taxpayer. 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 in this ruling is whether the grain payments made by Taxpayer to members and eligible nonmember patrons for grain qualify as per-unit retain allocations paid in money within the meaning of section 1388(f) of the Code.

Under section 199 of the Code and section 1.199-6 of the regulations, the answer to this question determines who gets to include the grain payments in the section 199 computation. If the grain payments to members and eligible nonmember patrons are per-unit retain allocations paid in money, then they should be added-back in Taxpayer's section 199 computation and not included in the members' and eligible nonmember patrons' section 199 computations. If the grain payments to members and eligible nonmember patrons are not per-unit retain allocations paid in money, then they should not be added-back in Taxpayer's section 199 computation, but should be included in the members' and eligible nonmember patrons' section 199 computations. These results are the same whether Taxpayer decides to keep or to pass-through all or a portion of its section 199 deduction.

According to Taxpayer, grain marketing cooperatives such as Taxpayer have never thought of their grain payments as per-unit retain allocations paid in money. However, Taxpayer's grain 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 grain payments are made in cash so the "paid in money" requirement is met. Taxpayer's grain 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, Taxpayer's grain payments to a member or an eligible nonmember patron are paid "pursuant to an agreement," namely the particular agreement applicable to the method the member or eligible nonmember patron uses to determine how and when his or her grain is sold to Taxpayer.

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

Third, the amount of the grain payments to each member or eligible nonmember patron "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.

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. Rev. Rul. 68-236, 1968-2 C.B. 236, provides that "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 and eligible nonmember patrons do not receive the same payments for their grain (i.e., that Taxpayer does not pool) does not mean that grain 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), 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 in Farm Service Cooperative v. Commissioner, 70 T.C. 145, 147-148 (1978), 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.”

Because of its fiscal year end, most of the grain that members and eligible nonmember patrons deliver to Taxpayer for marketing each year is sold by year-end. During its fiscal year ended , Taxpayer's grain purchases (member and nonmember) were approximately \$, and its closing grain inventory valued at market was approximately \$. Thus, only about percent of the grain Taxpayer purchased during the course of fiscal was on hand at year end.

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.

Taxpayer's grain payments qualify as per-unit retain allocations within the meaning of section 1388(f) of the Code because they are: (1) distributed with respect to grain that Taxpayer markets for its patrons; (2) the patrons receive the payments based on the quantity of grain delivered; (3) the grain payments are determined without reference to Taxpayer's net earnings; (4) the grain payments are paid pursuant to a contract with the patrons establishing the necessary pre-existing agreement and obligation; and (5) the grain payments 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."

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 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.

For reasons described above, Taxpayer's grain payments meet the definition of "per-unit retain allocations paid in money." Taxpayer may disregard such payments in determining the amount of its section 199 deduction.

Accordingly, we rule as requested that:

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

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 grain payments made during a year attributable to grain which is sold by Taxpayer during the year. No opinion is expressed or implied as to whether grain payments made during a year attributable to grain 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)

cc: