Office of Chief Counsel
Internal Revenue Service

Memorandum

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to: Supervisory Internal Revenue Agent,
Pre-Filing & Technical Guidance
Technical Advisors Group 2
(Large & Mid-Size Business)

from: Paul Handleman, Senior Technician Reviewer, Branch 5, Office of the Associate Chief Counsel (Passthroughs & Special Industries), CC:PSI:5

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subject: Cooperatives Using Pooling and § 199

This memorandum responds to your e-mail dated October 16, 2007, regarding marketing cooperatives that use pooling and calculate a deduction under § 199 of the Internal Revenue Code. Your e-mail specifically questions whether the conclusions in a memorandum from Industry Counsel (Cooperatives), dated September 29, 2006, allow marketing cooperatives using pooling a larger § 199 deduction than marketing cooperatives that do not use pooling. The § 199 deduction from gross income is based on an applicable percentage of qualified production activities income (QPAI) subject to certain limits. We reviewed the Industry Counsel memorandum and agreed with its conclusions in a Chief Counsel Advice dated September 13, 2006.

After reviewing your e-mail, we continue to agree with the Industry Counsel memorandum‘s conclusion that per-unit retains paid in money (PURPIMs) are deductible by a marketing cooperative using pooling whether or not the product marketed for the farmers has been sold during the taxable year. While the Industry Counsel's memorandum discusses many aspects of this issue with which we agree, our primary reason for our conclusion is the clear language of the statute. Specifically, under § 1382(b)(3), in determining the taxable income of a cooperative, PURPIMs are treated as a deduction in arriving at gross income "with respect to marketing occurring during the taxable year." Section 1382(e)(2) provides that, for purposes of § 1382(b), in the case of a pooling arrangement for the marketing of products, "the marketing of

products shall be treated as occurring during any of the taxable years in which the pool is open." [emphasis added].

Hence, the Code on its face makes clear that "marketing" is deemed to occur in any taxable year the pool is open and there is no requirement that the cooperative to have actually made sales to third parties commensurate with the dollar amount of PURPIMs paid to patrons to be allowed the deduction under § 1382(b)(3). This is also consistent with the fundamental purpose for the passage of subchapter T in 1962 which was and is to insure that there is one level of tax at the cooperative or patron level. Here there is a deduction by the cooperative but a concomitant inclusion of income by the patrons for the PURPIMs.

In our view, your e-mail's conclusion that a pooling cooperative's § 199 deduction will be larger than another marketing cooperative's § 199 deduction that does not use pooling is incorrect. In the example you provided with the e-mail (copy attached), the non-pooling-marketing cooperative makes a $10,000 cash payment to patrons in exchange for product in March, processes the product, sells the product during the same taxable year, and makes a final patronage dividend payment of all net earnings. The example concludes that the § 199 deduction for this cooperative will be lower than the pooling cooperative because the original cash payment will be in cost of goods sold (thereby reducing QPAI) whereas the PURPIMs paid by the pooling cooperative will not be in cost of goods sold resulting in a larger amount of QPAI and, consequently, a larger § 199 deduction.

The example fails, first, to recognize that the $10,000 March cash payment by the non-pooling-marketing cooperative to the patrons itself meets the definition of a PURPIM in §§ 1388(f) and 1382(b)(3) and would be deductible by the non-pooling cooperative in the same manner as the pooling cooperative resulting in identical § 199 calculations and § 199 deductions. This is the case even if the "with respect to marketing occurring during the taxable year" in § 1382(b)(3) means that the cooperative must make actual sales to third parties of the product to get the deduction since the non-pooling cooperative in your example has made such sales.

Second, even if the analysis in your e-mail was correct, simple planning would get both cooperatives the same § 199 deduction amount by having the non-pooling cooperative not making a cash payment upon delivery of the product but merely paying $15,000 as a patronage dividend.

Lastly, what the non-pooling example seems to disregard is that even if the $10,000 amount was excluded from the non-pooling cooperative's § 199 calculation, the $10,000 would be domestic production gross receipts (DPGR) under § 199(c)(4)(A)(i)(I) to the patrons. So, ultimately, there may be $15,000 of QPAI no matter what; it would just be split between the cooperative and the patrons.

The express purpose of § 1.199-6(c) and (l) of the Income Tax Regulations is to have the entire § 199 calculation done at the cooperative level and not splitting it between patrons and the cooperative. Under § 1.199-6(l), PURPIMs, per-unit retains in qualified certificates, and qualified patronage dividends are never DPGR to the recipient patron(s) whether or not the cooperative passes through the § 199 deduction. The position advocated in the e-mail is contrary to that express purpose. However, the correct answer that the "purchases" are in fact PURPIMs in the examples involving non-pooling and pooling cooperatives fulfills that regulatory purpose as well.

We also note that, to prevent a cooperative from deducting the PURIMs for the second time when the product is sold, the Industry Counsel's memorandum concludes that the cost of goods sold mechanism associated with inventory must be adjusted to reflect the deductions allowable under subchapter T. If the PURPIMs are deducted on a deduction line in the cooperative's tax return, then they should be removed entirely from the ending inventory and cost of goods sold computed for the taxable year. Alternatively, if the PURPIMs are not deducted on a deduction line in the tax return, the PURPIMs reflected in the ending inventory should be removed and included in the cost of goods sold amount for that taxable year. The memorandum recommends this procedure to allow the cooperative to deduct the PURPIMs once while also preserving the integrity of the cooperative's § 263A calculation. This procedure recognizes that PURIMs may be removed from the cost of goods sold computation regardless of whether a marketing cooperative uses pooling.

In accordance with § 6110(k)(3), this document may not be used or cited as precedent. Please call me at (202) 622-3040 if you have any further questions about this matter.

Attachment:

Pooling Cooperatives and IRC 199 excel spreadsheet dated 15-May-07.

POOLING COOPERATIVES AND IRC 199 15-May-07

Simple example of IRC 199 coop provisions

Reg. 1.199-6(c) Determining cooperative's qualified production activities income and taxable income. For purposes of determining its section 199 deduction, the cooperative's qualified production activities income (QPAI) (as defined in §1.199-1(c)) and taxable income are computed without taking into account any deduction allowable under section 1382(b) or (c) (relating to patronage dividends, per-unit retain allocations, and nonpatronage distributions).

applied to Chief Counsel's recent interpretation of pooling accounting.

i.e. Any cash payments made by a "pooling" cooperative to a patron on a "per-unit" basis, regardless of sales, are per-unit retains paid in money per 1382(b)(3) and not allowed as part of COGS

Assume calendar year cooperative acquires, processes and markets 100% of patrons' product during the year.
The coop pays the patrons the listed market price ($10/unit) for raw product (1,000 units) upon delivery.

March -	Coop makes cash payments to patrons upon delivery	(10,000)
June -	Coop incurs processing and overhead costs associated with product	(5,000)
Sept -	Coop sells patrons' processed product	20,000
Dec -	Patronage net earnings are determined	5,000
	Patronage net earnings are distributed per IRC 1382(b)(1)	(5,000)
	Coop's taxable income	0

If the cooperative does NOT use pooling accounting, its 199 computation is as follows:

DPGR -	20,000
COGS -	
Purchases	(10,000)
Processing & OH	(5,000)
QPAI -	5,000

The cooperative's Taxable income is computed without deductions allowable under IRC 1382(b)&(c)

Coop's T.I.	0
add 1382(b)(1) deduction	5,000
Coop's T.I. for 199(a) comp	5,000

IRC 199 deduction is equal to 3, 6 or 9% of the lessor of QPAI or T.I. or $5,000.

Pooling cooperatives, following CC's pooling interpretation, would account for the same transactions as follows:

DPGR -	20,000
COGS -	
Processing & OH	(5,000)
QPAI -	15,000

The cooperative's Taxable income is computed without deductions allowable under IRC 1382(b)&(c)

Coop's T.I.	0
add 1382(b)(1) deduction	5,000
add 1382(b)(3) deduction	10,000
Coop's T.I. for 199(a) comp	15,000

IRC 199 deduction is equal to 3, 6 or 9% of the lessor of QPAI or T.I. or $15,000.