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LEGEND

Coop =

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Dear

This is in response to your request for rulings dated April 16, 2008, submitted by your authorized representative. The rulings concern the interplay of the rules in subchapter T of the Internal Revenue Code (concerning the taxation of cooperatives and their patrons) and the calculation of the section 199 deduction for certain cooperatives contained in section 199(d)(3).

Coop is a nonexempt cooperative that is organized under the laws of State. Coop markets the c of its b members. Coop has a December 31 year end. According to the facts submitted, Coop enters into c marketing and membership agreements with its members. The agreements may be one-year agreements, thirty- day agreements or commodity pool agreements. The one-year agreement is the most common. After its initial term, the one-year agreement is automatically renewable for one-year terms unless either party elects to terminate the agreement. The thirty-day agreement is identical to the one-year agreement except that it has a thirty-day term and is automatically renewable for thirty-day terms unless either party elects to terminate. Members who enter into either of these agreements participate in Coop's Value-Added Pool. The third form of agreement is the commodity pool agreement.

Under the terms of the one-year agreement (the Marketing Agreement), a member agrees to produce and deliver to Coop all of the merchantable c produced at the member's facility or facilities listed in the Agreement. In the Marketing Agreement, Coop agrees to receive the c, sell the same and account for the proceeds on a pool basis. The member is required to warrant that all c delivered to Coop will comply with all applicable laws and regulations and with the quality standards set by Coop.

Coop's practices for paying its members for c reflect the system that has existed in the United States for many years. The market regulation of c is largely controlled by the federal government. The federal government is authorized to regulate the marketing of c by establishing federal marketing orders for c in the various regional c markets. The purpose for the market order system for c is to develop a steady and dependable market for c and to help correct conditions that result in price instability and disorderly marketing of c.

The market orders generally set the minimum price that must be paid by handlers to c producers, however, cooperatives are not required to pay that price. Cooperatives are free to determine how they share the net proceeds from the sale of members' c.

At present, Coop distributes the net proceeds from the marketing of c in two forms: 1) semi-monthly c checks and 2) patronage dividends paid after the close of the year when net earnings for the year have been determined. Coop makes an advance to producers for c delivered during the first 15 days of each month on or about the 25th of the month. That advance is based upon what Coop anticipates paying for the c for the month. However, Coop does not pay out the entire anticipated amount in the initial advance, but rather pays out a high percentage, holding back the remainder in the case the actual amount turns out to be less than anticipated. After the end of the month and the market order price is determined, Coop determines what each member is to be paid for c delivered during the month in the form of c checks and sends a second check to the member for that amount. After the end of the year, b members receive a patronage dividend paid out of the Coop's net earnings for c delivered during the course of the year.

Coop believes that c checks should be classified as "per-unit retain allocations paid in money," not as "purchases." Coop plans to begin reporting c checks in that manner, starting with its Year tax return. For purposes of its section 199 computation for Year, Coop intends to disregard c checks (as well as patronage dividends) and it plans to pass through to its members the portion of the section 199 deduction that Coop will not be able to use.

The following rulings are requested:

1. The c checks that Coop pays to b members each year for c delivered to Coop 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, Coop’s qualified production activities income and taxable income should, pursuant to section 199(d)(3)(C) of the Code, be computed without regard to any deduction for the c checks.

Section 1388(f) of the Code defines the term “per-unit retain allocation” to mean “any allocation, by an organization to which Part I of this subchapter applies, to a patron with respect to products marketed for him, the amount of which is fixed without reference to net earnings of the organization pursuant to an agreement between the organization and the patron.”

Per-unit retain allocations (PURs) may be made in money, property or certificates. Per-unit retain allocations paid in money and in property are excludable or deductible under section 1382(b)(3) of the Code. Per-unit retain allocations paid in certificates are deductible under section 1382(b)(3) if the certificates are qualified. If the certificates are nonqualified, the cooperative is permitted a deduction under 1382(b)(4) (or a tax benefit figured under section 1383) when the certificates are later redeemed.

Section 1388(a)(1) of the Code provides that the term “patronage dividend” means an amount paid to a patron by a cooperative on the basis of the quantity or value of business done with or done for such patron. Section 1388(a)(2) provides that a “patronage dividend” is an amount paid “under an obligation” that must have existed before the cooperative received the amount so paid. Section 1388(a)(3) provides that “patronage dividend” means an amount paid to a patron that is determined by reference to the net earnings of the cooperative from business done with or for its patrons. That section further provides that a “patronage dividend” does not include any amount paid to a patron to the extent that such amount is out of earnings other than from business done with or for patrons. Section 1.1382-3(c)(2) of the Income Tax Regulations states that income derived from sources other than patronage means incidental income derived from sources not directly related to the marketing, purchasing, or service activities of the cooperative association.

Section 1382(a) of the Code provides that except as provided in section 1382(b), the gross income of any cooperative shall be determined without any adjustment (as a reduction in gross receipts, an increase in cost of goods sold, or otherwise) by reason of any allocation or distribution to a patron out of net earnings or by reason of any amount paid to a patron as per-unit retain allocations.

Section 1382(b)(1) of the Code provides, in part, that in determining the taxable income of a cooperative there shall not be taken into account amounts paid during the payment period for the taxable year as patronage dividends to the extent paid in money, qualified written notices of allocation, or other property with respect to patronage occurring during such taxable year.

Section 1.1382-2(b)(1) provides, in part, that there is allowed as a deduction from the gross income of any cooperative to which part I of subchapter T applies, amounts paid to patrons during the payment period for the taxable year as patronage dividends with respect to patronage occurring during such taxable year, but only to the extent that such amounts are paid in money, qualified written notices of allocation, or other property (other than nonqualified written notices of allocation). Section 1388(d) of the Code defines the term “nonqualified written notices of allocation” as meaning a written notice of allocation other than a qualified written notice of allocation, or a qualified check that is not cashed on or before the 90th day after the close of the payment period for the taxable year for which the distribution of which it is part is paid.

Section 1382(b)(3) of the Code provides, in part, that in determining the taxable income of a cooperative there shall not be taken into account amounts paid during the payment period for the taxable year as per-unit retain allocations paid in money, other property, or qualified certificates with respect to marketing occurring during such taxable year.

Section 1382(e) of the Code provides that for purposes of section 1382(b), in the case of a pooling arrangement for marketing products, the patronage shall be treated as occurring during the taxable year the pool closes, and the marketing of products shall be treated as occurring during any taxable years the pool is open.

Though section 1382 of the Code is awkwardly drafted, the flush language of section 1382(b) clarifies what it means for an item not to be “taken into account.” It states that, “for purposes of this title,” a patronage dividend is treated as “an item of gross income and as a deduction therefrom,” and a per-unit retain allocation in money or qualified certificates are treated as a “deduction in arriving at gross income.”

Section 1382(d) of the Code provides, in part, that the payment period for any taxable year is the period beginning with the first day of such taxable year and ending with the fifteenth day of the ninth month following the close of such year.

Thus, per-unit retain allocations paid in money or qualified certificates are deductions in arriving at gross income if paid with respect to an open pool within the payment period for the taxable year. Because patronage dividends paid in money and qualified certificates are treated as deductions in arriving at gross income, Form 990-C (and new form 1120-C) requires such dividends to be reported on Schedule H as a deduction from gross income. Because per-unit retain allocations paid in money or qualified certificates are treated as a "deduction in arriving at gross income" they are reported on Schedule A of the Form 990-C which represents the cooperative's cost of goods sold. This does not change the fact that Coop is allowed a full deduction under section 1382(b) of the Code for per-unit retains paid in money or qualified certificates.

We note that to prevent a cooperative from deducting the per-unit retain allocations made in money or qualified certificates for the second time when the associated product is sold, the cost of goods sold mechanism associated with inventory must be adjusted to reflect the deductions allowable under subchapter T. Specifically, cooperatives need to include the PURs in inventory cost for purposes of making inventory and section 263A of the Code computations and then adjust the ending inventory and cost of goods sold to prevent double deduction of the PURs. The adjustments can be made to either the inventory or the line item deduction for the PURs. In other words, if the PURs are deducted on a deduction line in the cooperative's tax return, they should be removed entirely from the ending inventory and cost of goods sold computed for the tax year. Alternatively, if the PURs are not deducted on a deduction line in the tax return, the PURs reflected in the ending inventory should be removed and included in the cost of goods sold amount for that tax year. This procedure will allow the cooperative to deduct the PURs once while also preserving the integrity of its section 263A calculation.

Under section 199(d)(3) of the Code, patrons that receive a qualified payment from a specified agricultural and horticultural cooperative are allowed a deduction for an amount allocable to their portion of the qualified production activities income (QPAI) of the organization received as a qualified patronage dividend or per-unit retain allocation which is paid in qualified per-unit retain certificates. In particular, section 199(d)(3)(F) requires the cooperative to be engaged in the manufacturing, production, growth, or extracted (MPGE) in whole or significant part of any agricultural or horticultural product, or in the marketing of agricultural or horticultural products. Under section 199(d)(3)(D), in the case of a cooperative engaged in the marketing agricultural and horticultural products, the cooperative is treated as having 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), for purposes of determining a cooperative's section 199 deduction, the cooperative's QPAI and taxable income are computed without taking into account any deduction allowable under section 1382(b) or (c) of the Code (relating to patronage dividends, per-unit retain allocations, and nonpatronage distributions).

An agricultural or horticultural cooperative is permitted to "pass-through" to its patrons all or any portion of its section 199 deduction for the year provided it does so in the manner and within the time limits set by section 199(d)(3) of the Code. When a cooperative passes-through all or any portion of the section 199 deduction, the cooperative remains entitled to claim the entire section 199 deduction on its return (provided that it does not create or increase a patronage tax loss), but is required under section 199(d)(3)(B) to reduce the deduction or exclusion it would otherwise claim under section 1382(b) for per-unit retain allocations and patronage dividends.

Section 1.199-6(l) provides: "No double counting. A qualified payment received by a patron of a cooperative is not taken into account by the patron for purposes of section 199."

Section 1.199-6(e) defines the term qualified payment to mean any amount of a patronage dividend or per-unit retain allocation, as described in section 1385(a)(1) or (3) of the Code received by the patron from a cooperative, that is attributable to the portion of the cooperative's QPAI, for which the cooperative is allowed a section 199 deduction. For this purpose, patronage dividends and per-unit retain allocations include any advances on patronage and per-unit retains paid in money during the taxable year.

Section 1.199-6(k) provides that the final regulations are the exclusive method for the cooperative and its patrons to compute the amount of the section 199 deduction.

The effect of these sections is that the cooperative will compute the entire section 199 deduction at the cooperative level and that none of the distributions whether patronage dividends or per-unit retain allocations received from the cooperative will be eligible for section 199 in the patron's hands. That is, the patron may not count the qualified payment he receives from the cooperative in his own section 199 computation whether or not the cooperative keeps or passes through the section 199 deduction. Accordingly, the only way that a patron can claim a section 199 deduction for a qualified payment received from a cooperative is for the cooperative to pass-through the section 199 amount in accordance with the provisions of 199(d)(3) of the Code and the regulations thereunder.

Coop's c checks qualify as per-unit retain allocations within the meaning of section 1388(f) of the Code because they were distributed with respect to c that Coop markets for its patrons, and by the fact that the patrons receive the payments based on the quantity of c delivered; the c checks are determined without reference to the Coop's net earnings; the c checks were paid pursuant to a contract with the patrons establishing the necessary pre-existing agreement and obligation; and the c checks were paid within the payment period of section 1382(d).

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

(1) The c checks that Coop pays to b members each year for c delivered to Coop constitute “per-unit retain allocations paid in money” within the meaning of section 1382(b)(3) of the Code.

(2) In computing Coop’s section 199 domestic production deduction, Coop’s qualified production activities income and taxable income should, pursuant to section 199(d)(3)(C) of the Code, be computed without regard to any deduction for the c checks.

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: