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November 24, 2008

LEGEND

Coop =

Geographic Area =

State A =

b =

c =

d =

e =

f =

Dear :

This is in response to a request for rulings dated July 24, 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 A. The members of Coop are b farmers who deliver their c to Coop. The members enter into a Marketing Agreement with Coop under which they agree to deliver c in accordance with Coop's Bylaws. Under the terms of the Marketing Agreement, each b farmer member of Coop is obligated to sell all c produced by him or her for market, to Coop. In return, Coop agrees to market the highest grade c produced by the member during the term of the agreement. Members are located throughout the Geographic Area.

Coop markets the c of its b farmer members, that is, producers of c who have entered into a Marketing Agreement and who have acquired one share of Coop common stock, on a patronage basis. Coop also, from time to time, markets c delivered by e other b cooperatives. The e cooperatives are members of Coop, owning one share of common stock each, and entitled to share in Coop's patronage dividends.

Coop has a d year end. At the end of each year Coop computes its net proceeds and distributes patronage income to its members.

Coop's practices for paying its b members for c reflect the system that has existed in the United States for many years for regulating c marketing. 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. 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. This helps guarantee consumers a stable supply of c while at the same time providing a reasonable return for b producers.

While the market orders generally set the minimum price that must be paid by handlers to b producers within the market order and each zone in the market order, cooperatives are not required to pay that price. Cooperatives are free to determine how they share the net proceeds from the sale of their members' c.

At present, Coop distributes the net proceeds from c marketing in two forms: 1) semi-monthly c checks and 2) patronage dividends paid after the close of the year and net earnings for the year have been determined. Coop generally follows the practice of making an advance to producers for c delivered during the first 15 days of each month on or about the 26th day of the month. That advance is based upon c order prices from the prior month. After the end of the month when the producer price differential and the zone differentials for the month have been determined, Coop determines what each member is to be paid for the c delivered during the month and sends a second c check to the member for the difference between that amount and the advance.

Coop refers to the amount it pays for c as the "pay price." The pay price is paid in cash. Thus, a member who delivers c throughout the year receives 24 c checks each year. These c checks are the subject to the ruling request.

As discussed below, for federal tax purposes, the advance payments, or c checks are considered advances on the net proceeds and treated as "per-unit retains paid in money." Accordingly, for purposes of its section 199 computation for its fiscal year ending f, Coop intends to disregard c checks (as well as patronage dividends) and it plans to pass through to its members all or a portion of the section 199 deduction.

Nonexempt subchapter T cooperatives are permitted to exclude or deduct distributions to their patrons that qualify as patronage dividends or per-unit retain allocations, provided those distributions otherwise meet the requirements of subchapter T of the Code.

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

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

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

Section 1382(a) of the Code provides that, except as provided in section 1382(b), the gross income of any cooperative shall be determined without any adjustment (as a

reduction in gross receipts, an increase in cost of goods sold, or otherwise) by reason of any allocation or distribution to a patron out of net earnings or by reason of any amount paid to a patron as per-unit retain allocations.

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

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

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

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

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

Under section 199(d)(3) of the Code, patrons that receive a qualified payment from a specified agricultural or horticultural cooperative 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 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), for purposes of determining a cooperative's section 199 deduction, the cooperative's QPAI and taxable income are computed without taking

into account any deduction allowable under section 1382(b) or (c) of the Code (relating to patronage dividends, per-unit retain allocations, and nonpatronage distributions).

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

Section 1.199-6(l) provides that a qualified payment received by a patron of a cooperative is not taken into account by the patron for purposes of section 199.

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

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

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

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 that:

(1) The c checks that Coop pays to its b members and cooperative 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 activities 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
Chief, Branch 5
Office of the Associate Chief Counsel
(Passthroughs & Special Industries)

cc: