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August 13, 2009

LEGEND

Taxpayer =

Subsidiary =

b =

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Dear :

This is response to a request for rulings dated March 23, 2009, submitted by your authorized representatives. The ruling concerns the interplay of the rules in section 199 of the Internal Revenue Code as they relate to subchapter T cooperatives.

Taxpayer is a nonexempt agricultural cooperative that processes b products on behalf of its c farm members. Taxpayer is a pooling marketing cooperative and distributes the net proceeds to the members through monthly pools and an annual patronage dividend. Subsidiary is a wholly owned subsidiary of Taxpayer and is also a nonexempt agricultural cooperative. Taxpayer and Subsidiary are both calendar year taxpayers and file separate federal income tax returns. Subsidiary purchases b products such as d from Taxpayer and sells them in the retail market. Subsidiary pays a negotiated price under a contract to Taxpayer for its products. Inventories are computed under sections 471 and 263A of the Code. At the end of each year,

Subsidiary computes its patronage source income and distributes a patronage dividend to its parent, Taxpayer. Subsidiary does not operate as a pooling cooperative but rather as a non-pooling cooperative. However, its bylaws require that patronage losses be recouped from patronage income, either through loss carrybacks or carryforwards. The board has the authority to determine the method to be used when losses occur.

Both Taxpayer and Subsidiary are eligible to compute the section 199 deduction based on their domestic production activities. Taxpayer is eligible to compute its section 199 deduction for patronage income purposes by adding back the monthly "b Check" (i.e., per-unit retain paid in money) advances made on the monthly pools and the patronage dividend. Subsidiary computes its section199 deduction for patronage income purposes by adding back the patronage dividend but not the amount paid to its parent, Taxpayer, for the b products. Taxpayer represents that it and its Subsidiary are members of the same Expanded Affiliated Group.

Taxpayer is a specified agricultural or horticultural cooperative because it is a cooperative to which Part I of subchapter T of the Code applies and the cooperative has manufactured, produced, grown, or extracted (either directly or through attribution) and marketed an agricultural product, b supplied by the members. The special "attribution" rule for marketing cooperatives under section 199(d)(3)(D) applies to Taxpayer and Subsidiary; the activities of the patrons as producers of b is attributed to Taxpayer and Subsidiary whether Taxpayer and Subsidiary actually does any processing of the b or not.

Taxpayer and Subsidiary have significant W-2 wages from their respective business operations. If the various calculations were applied purely on a separate company basis, Taxpayer's section 199 deduction would, however, be limited to 50 percent of its W-2 wages due to the significant amount of its separate company section 199 deduction as determined before application of the W-2 wage limitation; and Subsidiary's section 199 deduction would not be limited by 50 percent of its W-2 wages as its separate company section 199 deduction as determined before application of the W-2 wage limitation (disregarding the amount paid directly for b products).

Cooperatives are permitted to benefit from the section 199 deduction under section 199(d)(3) of the Code. The section 199 rules for cooperatives are intended to apply to any agricultural or horticultural cooperative that has qualified production activities income, whether the cooperative is a marketing cooperative or a supply cooperative. In addition, the provision contains a special rule (the "cooperative attribution rule") treating a marketing cooperative as having manufactured, produced, grown or extracted (MPGE) the product if its patrons manufactured, produced, grew or extracted the product.

Section 199(a)(1) of the Code allows a deduction equal to 9 percent (3 percent in the case of taxable years beginning in 2005 or 2006, and 6 percent in the case of

taxable years beginning in 2007, 2008, or 2009) of the lesser of: (a) the qualified production activities income (QPAI) of the taxpayer for the taxable year; or (b) taxable income (determined without regard to section 199) for the taxable year (or, in the case of an individual, adjusted gross income).

Section 199(b)(1) of the Code limits the deduction for a taxable year to 50 percent of the W-2 wages paid by the taxpayer during the calendar year that ends in such taxable year. For this purpose, section 199(b)(2) defines the term W-2 wages to mean the sum of the aggregate amounts the taxpayer is required under section 6051(a)(3) and (8) to include on the Forms W-2, "Wage and Tax Statement," of the taxpayer's employees during the calendar year ending during the taxpayer's taxable year.

Section 199 allows a cooperative to deduct 9 percent (when fully phased in) of the lesser of its QPAI or taxable income (determined without regard to section 199) from gross income and thus reduce otherwise taxable income of the cooperative. In order to determine a "profit" on which to compute the section 199 benefit, Congress provided that certain distributions to patrons would not be taken into account and thus would be deemed to be the "profit" of the cooperative. This provision was intended to give the cooperative a method of computing a benefit under the rules. After computing the amount of the section 199 deduction (taking into account the limitation based on the applicable percentage of taxable income), the cooperative must compare that amount to 50 percent of the cooperative's W-2 wages, and the deduction is limited to the lower of the two amounts.

Section 1.199-2 of the Income Tax Regulations provides guidance on the application of the W-2 wage limitation for taxpayers computing a section 199 deduction. The amount of the section 199 deduction allowable is limited to 50 percent of the W-2 wages of the taxpayer. A taxpayer may take into account any wages paid by another entity and reported by the other entity on Forms W-2 provided that the wages were paid to employees of the taxpayer for employment by the taxpayer. W-2 wages must be included in a return filed with the Social Security Administration on or before the 60th day after the due date (including extensions) for such return. W-2 wages includes only that are properly allocable to domestic production gross receipts.

Section 1.199-6(i) provides that the W-2 wage limitation described in § 1.199-2 shall be applied at the cooperative level whether or not the cooperative chooses to pass through some or all of the section 199 deduction. Any section 199 deduction that has been passed through by a cooperative to its patrons is not subject to the W-2 wage limitation a second time at the patron level.

Section 1.199-7 prescribes the rules related to an expanded affiliated group (EAG). All members of an EAG are treated as a single corporation for purposes of section 199, except as otherwise provided in the Code and regulations. Each member

of an EAG is a separate taxpayer that computes its own taxable income or loss, QPAI, and W-2 wages. Section 1.199-7(b) provides that the section 199 deduction for an EAG is determined by the EAG aggregating each member's taxable income or loss, QPAI, and W-2 wages. Under § 1.199-7(c)(1), once the EAG section 199 deduction is computed it is allocated among the members of the EAG in proportion to each member's QPAI.

Section 1.199-7(a)(1) defines an EAG as an affiliated group as defined in section 1504(a), determined by substituting more than 50 percent for at least 80 percent each place it appears and without regard to section 1504(b)(2) and (4). A corporation must also determine if it is a member of an EAG on a daily basis. As noted earlier, Taxpayer has represented that it and Subsidiary are members of the same EAG.

Section 1504(b) includes all corporations under the definition of affiliated groups except entities specifically excluded. Nonexempt cooperatives are not excluded from such definition. Furthermore, nonexempt cooperatives have been affirmatively allowed to be included in consolidated returns in accordance with section 1504(b). This allows nonexempt cooperatives to be eligible for inclusion within the filing of consolidated federal tax returns and treated as members of an EAG for purposes of the section 199 deduction.

Section 1.199-6(h) provides that the cooperative may, at its discretion, pass through all, some, or none of the section 199 deduction to its patrons. The computation of the section 199 deduction is the same whether the cooperative passes through all, some, or none of the section 199 deduction to its patrons.

Due to Taxpayer's section 199 deduction being limited by the amount of its W-2 wages, Taxpayer wants to clarify the appropriate application of the W-2 wage limitation. Section 1.199-6(i) states that the W-2 wage limitation is applied at the cooperative level, whereas § 1.199-7 treats members of the same EAG as a single entity for computational purposes and W-2 wages are aggregated.

Section 1.199-7 applies to Taxpayer as a member of an EAG. In applying § 1.199-7, QPAI, taxable income, and W-2 wages are computed separately for each member of the EAG. Such amounts are aggregated together for all members of the EAG, at which level the QPAI, taxable income, and W-2 wage limitations are applied to compute the EAG's section 199 deduction. The EAG's section 199 deduction is allocated to each member based on its contribution to the EAG's QPAI.

Section 1.199-6(i) requires the W-2 wage limitation to be applied at the cooperative level whether or not the cooperative chooses to pass through some or all of the section 199 deduction. This allows a cooperative to compute its section 199 deduction based upon its activities and W-2 wages, while preventing the cooperative from aggregating any W-2 wages of the individual patrons to modify the W-2 wage

limitation amount. Section 1.199-6(i) further provides that any section 199 deduction that has been passed through by a cooperative to its patrons is not subject to the W-2 wage limitation a second time at the patron level. This prevents any further limitation of the section 199 deduction, calculated at the cooperative level, by an individual patron, who may or may not have any W-2 wages.

Section 1.199-6(i) prevents manipulation of the section 199 deduction by precluding the cooperative from aggregating W-2 wages of the individual patrons and by restricting the application of the W-2 limitation a second time at the individual patron level. Section 1.199-6(i) does not supersede the EAG rules in § 1.199-7, rather both rules apply. Thus, cooperatives such as Taxpayer and Subsidiary aggregate their taxable income, QPAI, and W-2 wages (wages of the cooperative employees not of the individual patrons), compute their section 199 deduction, and apply the W-2 wage limitation to the EAG. Section1.199-6(i) does not override the application of the EAG rules in § 1.199-7.

Based solely on the foregoing facts, law, and analysis we rule that:

Taxpayer should apply the W-2 limitation in accordance with the EAG rules in § 1.199-7. Specifically, Taxpayer should apply the W-2 limitation as if all members of EAG were a single corporation and allocate the section 199 deduction to the EAG members in proportion to their contribution to the EAG's QPAI.

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 representatives.

Sincerely yours,

Paul F. Handleman

Paul F. Handleman
Chief, Branch 5
Office of the Associate Chief Counsel
(Passthroughs & Special Industries)