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LEGEND:

Taxpayer =

State A =

Product or Products =

City =

LLC =

b =

c =

d =

e =

Dear :

This is in response to a request for rulings dated July 10, 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 as a cooperative corporation under State A law. Taxpayer is a marketing cooperative serving Product growers. Currently, it has as members Product growers, principally located in Central and Southeastern State A.

Taxpayer was formed in in reaction to an announcement early in by that it planned to close its Product processing plant in City in December if a purchaser was not found. Faced with a loss of the market for their Products, a group of Product growers, who had been selling their Products to at that plant, banded together in a cooperative to purchase the City plant. The purchase closed in late .

Today, Taxpayer purchases Products from its members and sells them to LLC for slaughter and processing. Taxpayer is the majority owner of LLC, owning percent of the capital Units of LLC. From an economic perspective, the Units give Taxpayer the right to share in percent of the profit, loss and capital of LLC. From a control perspective, the Units give Taxpayer the right to cast percent of the votes on all matters that require member vote. Thus, Taxpayer controls LLC.

Taxpayer is organized and operated on a cooperative basis. Product growers interested in marketing Products through Taxpayer must apply for and be approved for membership in Taxpayer and purchase one share of membership common stock (Class A stock). In addition, they are required to acquire delivery rights for the number of Products they plan to sell to Taxpayer each year and to enter into a Product Marketing Agreement.

Taxpayer is what is commonly referred to as a "closed cooperative." Taxpayer's capacity (through LLC) to slaughter and process Products each year is limited, and it wants members to supply Products to it on a regular basis throughout the year so that LLC's plants can run continuously and efficiently. To balance its members' supply of Products with Taxpayer's capacity to market the Products (through LLC), Taxpayer has created delivery rights. In simple terms, each delivery right gives the holder the right to deliver one Product per year to Taxpayer. The aggregate amount of delivery rights is set to maintain a balance between the Products supplied to Taxpayer, and Taxpayer's capacity to market the Products.

Taxpayer historically has been capitalized in part by amounts members paid to acquire delivery rights. By tying capital contributions to delivery rights, the burden of providing capital to Taxpayer is shared among members in proportion to patronage. Taxpayer issued delivery rights when it was first formed. In established closed cooperatives, once all delivery rights have been issued, new members (or existing members wanting to increase production) must purchase or otherwise acquire delivery rights from an existing member (unless the cooperative's productive capacity is increased and new delivery rights are issued).

The Product Marketing Agreement establishes the terms upon which members market their Products through Taxpayer. When members deliver Products to Taxpayer, they are entitled to receive a cash payment for the Products determined in accordance with that agreement. Payments to members for their Products upon delivery are referred to as "Product payments."

Taxpayer immediately sells all the Products it purchases from members to LLC for slaughter, processing and marketing. Taxpayer purchases the Products in its own right, treating its purchase and sale of the Products as a purchase and sale for financial reporting and tax purposes. As purchaser of the Products, Taxpayer is required to comply with the requirements of the federal Packers and Stockyards Act.

After the end of the year, Taxpayer determines its net earnings from patronage sources for the year. This determination includes the patronage portion of its distributive share of the net earnings or loss of LLC. Taxpayer distributes its patronage-sourced net earnings to members each year as a patronage dividend.

The focus of Taxpayer's ruling request is on the amounts paid to members for their Products in the form of Product payments. Taxpayer is asking for confirmation that such payments qualify as per-unit retain allocations paid in money as that term is used in section 1382(b)(3) of the Code. Taxpayer is also asking for confirmation that, 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), be computed without regard to any deduction for such payments.

Taxpayer is organized as a cooperative corporation pursuant to the State A Cooperative Corporations Act (Chapter of the State A Code) (the "Act"). The Act was enacted in . Its stated purpose is:

> "…to provide an opportunity for producers of agricultural commodities to contribute a portion of their productions for a single enterprise for purposes of enhancing the value of that production and to restrict control of these enterprises to agricultural producers."

Taxpayer was one of the first cooperatives operating under the Act. Section provides for the distribution of the net savings of a cooperative organized under the Act as follows:

> "The board shall annually dispose of the cooperative's earnings in excess of its operating expenses as follows:
>
> 1. If the articles authorize the payment of distributions on a class of interests, then the directors may declare a distribution pursuant to the articles. Distributions shall not exceed eight percent of the value of the interest in each fiscal year. The members may control the amount that is allocated under this subsection.

2. To provide a reasonable reserve for depreciation, obsolescence, bad debts, or contingent losses or expenses. The members may control the amount that is allocated under this subsection.

3. To increase the cooperative's retained savings to the extent determined by the board to be necessary based on its evaluation of the future needs and the competitive position of the cooperative.

4. The cooperative shall have an unconditional binding obligation to distribute to the members all remaining net savings as determined under the United States Internal Revenue Code. These net savings shall be allocated to each member in proportion to the business the member did with the cooperative during the preceding fiscal year. The net savings may be separately calculated for two or more categories of business, and allocated to the members on the basis of business done within each of theses categories. Net savings shall be distributed in the form of cash or interests, or a combination of cash and interests, as determined by the Board."

Taxpayer's Third Amended and Restated Articles of Incorporation (the "Articles of Incorporation") provide that Taxpayer "is organized as a cooperative association under the provisions of Chapter of the [State A] Code."

Taxpayer is organized on a stock basis. It has outstanding shares of Class A stock. Class A stock is membership stock. In order to own Class A stock, a person must be "actively engaged in growing [Products]." Taxpayer's Bylaws provide that "[a]pplication for membership shall be received by the Board of Directors in the form of a subscription for common stock executed by the person or entity desiring membership."

Each Product grower member of Taxpayer is required to purchase one share of Class A stock, paying par value ($100) for the share. Class A stock does not bear dividends. Class A stock does have voting rights. Each Class A member is entitled to one vote on each issue presented to a vote of the membership. If a person ceases to be eligible to own Class A stock, Taxpayer has the right to redeem the person's share of Class A Stock at a redemption price equal to its par value.

Article V of Taxpayer's Bylaws provides a description of the disposition of its earnings and treatment of losses. The Bylaws begin by providing that Taxpayer "shall allocate and distribute to its members its adjusted net income from business done with them...." Bylaws, Article V, Section 1. The Bylaws then define "adjusted net income" as follows:

"In determining amounts distributable to members, the adjusted net income of the Association shall be equal to the Association's federal taxable income for the fiscal year determined without regard to the deduction for patronage dividends determined under Subchapter T of the

Internal Revenue Code of 1986, as amended. Such adjusted net income shall then be reduced by amounts not attributable to business done with members, by dividends required on preferred shares, if any, and by such reasonable reserves for necessary business purposes as may be determined by the Board of Directors prior to the beginning of the fiscal year."

Bylaws, Article V, Section 2.

The Bylaws then provide that Taxpayer shall use a single allocation unit. Bylaws, Article V, Section 2. Patronage distributions may be made in cash and in qualified or nonqualified written notices of allocation. It has been Taxpayer's practice to distribute patronage dividends percent in cash and percent in qualified written notices of allocation.

Article V, Section 8 of the Bylaws provides what Taxpayer may do in the event a loss is incurred:

> "In the event that the Association has a net operating loss as defined in Internal Revenue Code Section 172 (or any successor statute) attributed to business done with members, such loss may be charged against retained taxable income attributed to members for the three preceding years. If the net operating loss exceeds such amount, the excess shall be carried forward to offset taxable income attributed to business done with members in subsequent fiscal years. If the Board of Directors so elects, the entire amount of the net operating loss may be carried forward rather than back, to offset taxable income attributed to business done with members in subsequent fiscal years."

Bylaws, Article V, Section 8.

Article VIII of Taxpayer's Articles of Incorporation provides that upon dissolution assets will first be used to pay liquidation expenses and then to pay "obligations to creditors, except with respect to retained patronage distributions, in order of priority of such creditors as provided by law.…" Assets then are used to "pay each member the balance of retained patronage distributions in such member's capital account." Finally, any remaining assets are to be distributed "among the members pro rata based on their respective delivery rights under a Delivery Rights Agreement with the Cooperative." Basing the distribution of residual assets on delivery rights is a method of distributing those assets on the basis of patronage.

According to Taxpayer, to understand the Product Marketing Agreement it is necessary to understand what generally is involved in raising Products and in running a Product processing plant. In some b operations, processors operate and retain ownership of the b at all times in the growing process. The young c are delivered to growers, whose only responsibility is to care for them while they are growing to

maturity. The farmer supplies the land, facilities and labor. The processor supplies the young c, feed, litter, vitamins, veterinary services and other inputs necessary to raise the Product. Under this kind of the arrangement, most, but not all, of the growing risk is shifted to the processor.

That is not the manner in which Taxpayer operates. In Taxpayer's case, members are in charge of the entire growing process, including supplying necessary land, facilities and labor, acquiring young Products (referred to as d), feed, litter, vitamins, veterinary services and other inputs necessary to raise the Products, and generally managing all aspects of the grow-out process.

The critical document governing the relationship between Taxpayer and its members is the Product Processing Agreement. Under this Agreement, Taxpayer and each member agrees as to the number of d the member will acquire to grow out each year and when the member will acquire the d and begin the grow-out process. The member (referred to in the Agreement as "Owner") agrees:

> "…to place the number of [d] set forth on Schedule A in Owner's facilities, during the week also set forth on the attached Schedule A. Owner agrees to raise the [Products] using good animal husbandry and to sell the heavy live [Products] to Buyer, and Buyer agrees to purchase the [Products] from Owner, according to the marketing schedule to be determined from time to time by Buyer."

Agreement, Section 1(a).

The aggregate number of d that a member is scheduled to grow each year is determined by reference to the member's delivery rights. Taxpayer and members agree as to the time each member will begin to raise d so that the supply of Product will be kept in balance with the slaughter and production capacity of LLC. The scheduling also is done, to the extent possible, in such a manner that the member's sheds and grow-out sheds are generally kept in operation on a continuous basis. Members contract to deliver all of the Products in each e to Taxpayer, but do not guarantee that there will be a specified number of grown Products surviving at the end of the grow-out process. However, members are paid only for the live Products that they deliver.

Taxpayer determines the schedule for picking up Products ready for marketing and "in its sole discretion, may alter the scheduled time of pickup to maintain maximum efficiency at Buyer's processing facility." Agreement, Section 1(c). The member is required to notify Taxpayer in the event that it suffers excessive mortality in its e since that can affect scheduling at the City plant. Agreement, Section 1(a). Ten days prior to scheduled pickup, the member is required to count and weigh the Products and notify Taxpayer of the anticipated number and delivery weight. If the anticipated weight is not on average pounds per Product, Taxpayer may delay pickup until that weight is achieved. Agreement, Section 1(b).

Taxpayer is responsible for transporting the Products from the member's facilities to the City processing plant. Agreement, Section 2. The Products are weighed upon arrival at the City processing plant scale, and ownership passes from the member to Taxpayer at that time. Agreement, Section 2. Taxpayer may refuse to accept Products "that are not at the time of delivery free from damage, in compliance with applicable laws, free of disease and contamination, and in good health and merchantable condition." Agreement, Section 4(a). Members guarantee that the Products delivered to Taxpayer were raised in accordance with all applicable federal and state laws. Agreement, Section 4(b).

The price paid to members for their Products is determined in accordance with a formula set forth in Schedule B of the Agreement. Taxpayer agrees to "render a complete accounting and payment for all [Products] purchased within fourteen (14) calendar days by check or in sixteen (16) calendar days by electronic funds transfer from the time that they are slaughtered.…" The payment is made in cash. No portion is made in per-unit retain certificates.

The price paid for the Products is based upon the weight of the Products when delivered to the City plant. The price is computed starting with a base price, which is constant over the term of the Agreement and the same each year in all Agreements signed with members. Agreement, Section 3(a).

Section 1 of Schedule B of the Agreement contains a complicated formula for determining the base price for Products each year. The reason that the Agreement contains a formula, rather than the actual base price for the year, is that the base price is not known at the time the members sign the Agreement for the upcoming year.

The Agreement is for a term of one year, running from January 1 through December 31. Members sign new agreements each year. The Agreement applies to deliveries occurring during the course of the calendar year. It provides:

> "Buyer shall have no obligation to purchase any Products from Owner beyond the expiration date of this Agreement. Should Owner place [d] in anticipation of sale to Buyer beyond the expiration date of the Agreement, such [d] placement shall be at the sole risk of Owner, and Buyer shall have no obligation whatsoever to purchase such Products unless Buyer and Owner have fully executed a subsequent Product marketing agreement or a comparable instrument."

Agreement, Section 15.

So that members are assured that the d they place during the last few months of an Agreement will be covered by an Agreement, it is the practice of Taxpayer and its members to enter into Agreements for the subsequent year in August and September. At that time, the price to be paid for Products is not known. However, Taxpayer and its members have agreed on a formula for determining the price. That formula is contained

in Section 1 of Schedule B of the Agreement. By the first week in December, the price can be determined under the formula. Once determined, the base price is in effect for the subsequent calendar year.

The base price accounts for the bulk of what members are paid when they deliver Products to Taxpayer. However, there are several adjustments related to when members deliver Products to Taxpayer, the weight and condition of the Products delivered and whether the members have made efficient use of the transportation provided to them by Taxpayer.

All else being equal, heavier Products are more valuable to Taxpayer since they result in more meat for the same processing costs. There is an adjustment, referred to as the "weight incentive," that rewards growers for delivering heavier Products and penalizes growers for delivering lighter Products:

> "b. *Weight Incentive*. As an incentive to product heavier [Products], the final grower payment for each settlement will be calculated based upon the actual performance of the [e] as compared to the standard performance per the attached Schedule B, Section 2."

Agreement, Section 3(b). This incentive is determined based upon a comparison to the expected weight of Products for age, seasonally adjusted for the processing week.

Members are not paid for Products that die while being transported to the City plant. Agreement, Section 4(d). They also are not paid for Products or Product parts that are condemned after being delivered to the City plant so long as the condemnation is not plant-caused (i.e., so long as the condemnation relates to issues that existed when the condemned Products or Product parts were delivered to the plant). Agreement, Section 4(d). Since condemned Products place additional costs on Taxpayer and LLC, members are penalized by adjusting the delivered weight of the e (which includes Product and parts later condemned) for the condemned Product by

percent of the average weight for Product in the e. Agreement, Section 4(d).

Beyond this, there is what is referred to as a "condemnation incentive" to adjust the base price to reward members if condemnation of Products in their e is less than the norm and to penalize members if condemnation is greater than the norm:

> "c. *Condemnation Incentive*. As an incentive to improve the level of condemnation attributable to grower, loading, and hauling issues, the final grower payment for each settlement will be based upon the percent for total condemnation of the [e] (head and parts) and calculated for good live pounds per the attached Schedule B, Section 3."

Agreement, Section 3(c).

While Taxpayer has responsibility for transporting e from the member's farm to LLC, factors under the member's control can increase Taxpayer's transportation costs. Taxpayer schedules trucks to transport the member's e by multiplying the member's projected head count by the member's projected average weight, and dividing the Product by . If the projections are too low, Taxpayer's trucks may be overloaded and incur overweight fines and related costs. If the projections are too high, Taxpayer may have scheduled too many trucks and have incurred unnecessary additional transportation costs. These additional costs are charged to the member through what is referred to as the "live haul adjustment:"

> "d. *Live Haul Adjustment*. As an incentive to minimize live haul costs, the final grower payment for each settlement may include an adjustment for certain live haul costs relating to scheduling more trucks than necessary or overweight fines per the attached Schedule B, Section 4."

Agreement, Section 3(d).

> "In the event that more trucks were scheduled than necessary to haul the [e], Buyer will deduct the unnecessary additional costs from the settlement. If Buyer incurs overweight fines or related costs, Buyer will deduct the amount of such fines and costs from the settlement."

Agreement, Schedule B, Section 4. Finally, there is a seasonal adjustment to the base price to reflect the fact that members incur higher costs of propane to heat houses during the winter months.

Operating in the manner described above, Taxpayer made payments of approximately $ to members for their Products during its fiscal year ended . All of these payments were made in cash and were paid in accordance with the Product Marketing Agreements in effect during the fiscal year.

Taxpayer anticipates that it will be paying a patronage dividend to its member with respect to the fiscal year, but, at the time the ruling request was submitted, the audited financial statements for the year have not yet been completed and the amount of the patronage dividend has not yet been determined. As in the past, Taxpayer anticipates paying that patronage dividend percent in cash with the remainder in qualified written notices of allocation.

Taxpayer has treated Product payments as "purchases" for tax purposes and reported them on Schedule A, Line 2 of its Form 1120-C. Taxpayer has not reported Product payments 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 patronage dividends paid to members as a patronage dividend on Schedule H of its Form 1120-C.

Because of this reporting, Product payments have entered into the determination of Taxpayer's cost of goods sold for tax purposes. Because Taxpayer sells all live Products that its members deliver to it immediately upon delivery, Taxpayer does not

have any Products in inventory at year end. Thus, all Product payments made during the course of the year are deducted in that year as cost of goods sold.

Taxpayer has done a section 199 computation in prior years. In that computation it has not added-back Product payments, but it has added back patronage dividends. Taxpayer has not passed any portion of its section 199 deduction through to members in prior years.

Taxpayer has reconsidered how it should treat its Product payments for purposes of its tax return reporting and its section 199 computation. Based on the foregoing, Taxpayer request the following rulings:

1. Taxpayer's payments to members for Product 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 such payments to members for Product.

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 [subchapter T] 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 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 section 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. It is an organization “to which part I of subchapter T applies” (i.e., it is a nonexempt cooperative to which subchapter T applies). It is engaged “in the marketing of agricultural or horticultural products” (i.e., Product).

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 qualified production activities income 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.

Members marketing their Products through Taxpayer are entitled to receive Product payments during the course of each year in accordance with Taxpayer's Product Marketing Agreements. In addition, provided that Taxpayer has net earnings from patronage business (taking into account what has already been paid to members for their Products), they are entitled to receive a patronage dividend after year end.

Taxpayer's Product 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. Taxpayer's Product payments are paid in money by check or direct deposit so the "paid in money" requirement is met. Taxpayer's Product payments also meet all the requirements of the definition of "per-unit retain allocation" contained in section 1388(f), 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 Product payments are paid to Product growers pursuant to the State A Cooperative Corporations Act, Taxpayer's Articles of Incorporation and Bylaws, and Taxpayer's Product Marketing Agreements, and thus the "pursuant to an agreement" requirement is met.

Second, Taxpayer's Product payments to a member are made "with respect to Products marketed for him," namely, the Products delivered by the member for marketing by Taxpayer which Taxpayer resells to LLC. As noted above, all Products that members deliver to Taxpayer each year are sold during the year to LLC so Taxpayer does not have an inventory of unsold Products at year end.

Third, the amount of the Product payments to each member "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. At the time the base price is determined each year and the actual payments are made, while projections or estimates of Taxpayer's net earnings for the year may be made, Taxpayer's actual net earnings for the year are not known or determinable. When Taxpayer's net earnings are determined after the end of the year, if Taxpayer has net earnings from patronage basis, Product growers are entitled to an additional

distribution. This additional distribution is determined based upon Taxpayer's net earnings and is treated as a patronage dividend, not as a per-unit retain allocation.

Thus, Taxpayer's Product payments meet all the requirements specified in subchapter T of the Code for per-unit retain allocations. Since all payments are in cash by check, they qualify as per-unit retain allocations paid in money.

Historically, Taxpayer has not reported its Product payments in the manner that pooling cooperatives normally do. It has treated them as "purchases," not as "per-unit retain allocations paid in money or certificates." That does not mean that Taxpayer should be treated as a nonpooling cooperative. Economically, Taxpayer operates like pooling cooperatives do, where each person contributing to a pool each year receiving the same amount for his or her crop (except for quality and other similar adjustments).

Whether or not Taxpayer is pooling is a moot issue for purpose of this ruling because its Product payments meet the definition of "per-unit retain allocations paid in money" in any event. Nothing in subchapter T of the Code limits the exclusion or deduction for per-unit retain allocations to cooperatives with pools.

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 do not receive the same payments for their Products (i.e., that Taxpayer does not pool) does not mean that Products 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."

Section 1.199-6(k) of the regulations 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 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.

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 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 Product payments meet the definition of "per-unit retain allocations paid in money." Such per-unit retains are to be reported in box 3 of Form 1099-PATR, "Taxable Distributions Received From Cooperatives." Taxpayer should be entitled to disregard such payments in determining the amount of its section 199 deduction.

Accordingly, we rule as requested that:

1. Taxpayer’s payments to members for Product 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 such payments to members for Product.

No opinion is expressed or implied regarding the application of any other provision in the Code or regulations.

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: