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LEGEND:

Taxpayer =

State A =

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Dear :

This is in response to a request for rulings dated July 29, 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 tax-exempt farmers' marketing and purchasing cooperative organized under the laws of State A. Taxpayer has been doing business since . The existing entity was formed in with the merger of two historic farmers' cooperatives. Taxpayer applied for recognition of its tax-exempt status pursuant to section 521 of the Code in and filed its first return as a tax-exempt farmers' cooperative for its taxable year. Taxpayer's principal line of business is marketing b growth in the United States by its members.

Taxpayer also purchases commodities such as and other products, and supplies for resale to its members. Taxpayer purchases these commodities in bulk and resells them to its members. Taxpayer purchases and at and stores these products at its bulk facilities. These are sold to members in smaller quantities. Taxpayer is also engaged in the manufacturing and production of and .

Taxpayer's principal line of business is its purchase and resale of – primarily , but also and – grown by its members. Taxpayer enters into individual b purchase and sale agreements with its members. Pursuant to the terms of these agreements, members produce b and deliver it to Taxpayer at receiving and storage stations located throughout Taxpayer's trade territory. Members' typical growing seasons span the period that begins at planting in April and ends at harvest in September or October of the same calendar year. Most of Taxpayer's annual inventory, by volume, is delivered and accepted between April and November, although Taxpayer markets and sells the b year-round. Taxpayer grades its members' b upon receipt and agrees to receive and store the b products, to market the b on its members' behalf, to account for the proceeds of its marketing activities on a non-pooling basis, and to distribute those proceeds, less necessary expenses, to its members.

Taxpayer offers five alternate b delivery schedules and pricing mechanisms to its members in the written b contracts:

(1) <u>Fixed Price</u>, under which a member agrees to deliver a specified quantity of b at a particular place and within a fixed delivery window, and Taxpayer is obligated to purchase that b at a named price per c. Title does not pass to Taxpayer until the member delivers the b;

(2) <u>Basis Purchase,</u> in which a member agrees to deliver a specified quantity of b within a fixed delivery window, and Taxpayer is obligated to purchase that b at a price to be determined based on a negotiated discounted futures price. The discount, or basis, takes into account the difference between local market prices and Chicago Board of Trade futures prices. Taxpayer takes title to the b at delivery.

(3) <u>Future or Cash Purchase,</u> in which the member and Taxpayer agree on a price for b to be delivered within a certain delivery window, but the price calculation contains hedging and basis risk management features. Title to the b passes at delivery;

(4) Delayed Price, in which the member and Taxpayer agree to price at a later date gain that the member has already delivered to Taxpayer. The member may elect to price the b at any time before the contract termination date by notifying Taxpayer that he or she will accept Taxpayer's current bid (published daily). Title passes to Taxpayer at the time of delivery; and

(5) Spot Price, in which a member arrives at one of Taxpayer's receiving facilities with b and sells the b to Taxpayer at that day's current bid price.

Selection of a particular pricing mechanism depends on a number of factors, including Taxpayer's publishing bid prices, price trends, and cash needs of members. After taking delivery of its members' b, Taxpayer aggregates its inventory for bulk resale. Most of Taxpayer's sales are made to a river terminal facility in which Taxpayer holds a partial membership interest. Taxpayer also markets and sells its members' b to local , to local farmers for use as and to other local receiving and loading facilities for shipment to the west coast.

At the end of its fiscal year, Taxpayer closes its books with respect to business done with each member, at which time it calculates its margin with respect to business done with and on behalf of members. Taxpayer calculates its margin by first calculating its gross margin, or sales proceeds less overhead and other expenses. The gross margin is divided by the total number of c sold by Taxpayer to determine the gross margin per c. Taxpayer then multiplies the gross margin per c by the number of each member's c sold to calculate the member gross margin. The margin is then calculated by subtracting payments made by Taxpayer to the member in exchange for b from that member's member gross margin.

Members who do business with Taxpayer typically will receive distributions of the net proceeds of Taxpayer's marketing and sales activities in two forms: (1) advances, following delivery and acceptance of a member's b, based on and at the time called for by the pricing mechanism in the parties' written contracts; and (2) patronage dividends, calculated on a patronage basis and distributed at the end of each fiscal year, based on Taxpayer's net proceeds from its marketing and sales activities and in accordance with its Bylaws.

Advances by Taxpayer to its members are made in the form of checks in accordance with the members' agreements with Taxpayer and with State A cooperative law. These advance payments assure that Taxpayer and with State A cooperative law. These advance payments assure that Taxpayer remains competitive with non-cooperative b wholesalers and distributors, which generally pay producers for their b upon receipt.

Taxpayer does not use “pooling arrangements” or the completed crop pool method of accounting. In general, a cooperative using a pooling arrangement or the “completed crop pool” method of accounting commingles commodity products. Each producer is paid the average net price received at resale of the commodity making up the pool. Pooling is used to spread the risk of price fluctuations in commodity products, as well as expenses of the cooperative. According to Taxpayer, in such pooling arrangements, upon delivery (or shortly thereafter) producers receive one or more advances in the form of per-unit retain allocations. Because the price per unit with respect to a pooling cooperative is uniform for each commodity for the period of the pool, it is almost always necessary for the cooperative to make a final per-unit retain allocation to members based on the difference between the total advances previously received and the final price per unit determined after the pool closes. In addition, after the pool closes, a final distribution is made to producers in the form of a patronage dividend. The final distribution reflects the margin of the cooperative with respect to the product. Although all of the distributions to patrons other than the final patronage dividend are reflected in inventory costs for both accounting and tax purposes, all of the distributions are deductible for purposes of section 1382(b) of the Code.

In contrast, non-pooling cooperative (such as Taxpayer) negotiate individually with each producer with respect to the purchase price of the product. In general, non-pooling cooperatives divide the expenses of processing and the revenues from sales among their members. Non-pooling cooperatives resell their members’ products in bulk, and each member is allocated their share of the sale proceeds in proportion to the volume and quality of product the member delivered. Each member’s margin, however, depends on the price he or she agreed in advance to receive from the non-pooling cooperative. As a result, individual members of non-pooling cooperatives bear the burden and benefits of price fluctuations instead of spreading this risk among all members.

Historically, non-pooling cooperatives have labeled advance payments as cost of goods sold rather than per-unit retains allocations. Like per-unit retain allocations of pooling cooperatives, however, these costs of goods sold are capitalized into the cooperative’s inventory and recovered when that inventory is sold. Like pooling cooperatives, patronage dividends paid by non-pooling cooperatives to their members are accounted for as distributions deductible under section 1382(b) of the Code.

Taxpayer currently reports the advances paid to producers on Schedule A of Form 1120-C (previously Form 990-C) as cost of goods sold. Taxpayer reports amounts distributed to patrons as patronage dividends on Schedule H of such forms as a deduction from gross income. For financial accounting and bookkeeping purposes, prior to its current year, Taxpayer denominated such advances as costs of goods sold. For its current fiscal year, in Taxpayer’s accounting software, such advances have been denominated as per-unit retain allocations paid in money (PURPIMs).

For tax purposes, Taxpayer currently does not deduct advances made to members as PURPIMs. Instead, Taxpayer removes such advances from ending inventory and includes the advances in the "cost of goods sold" amount for its tax year. Thus, Taxpayer does not "double count" such advances for purposes of computing its tax liability or making inventory and section 263A of the Code computations**.**

According to Taxpayer, the economics of pooling and non-pooling cooperatives are virtually identical. The difference occurs at the individual member level, because producers negotiate and reach agreement separately with the cooperative with respect to the price of their product. As a result, each individual producer bears both the burden and the potential benefit of any market price fluctuations vis-à-vis the average price of the product marketed by the cooperative.

Under section 521 of the Code, exempt farmers' cooperative are defined as farmers', fruit growers' or other associations that are organized and operated on a cooperative basis for the purpose of marketing and selling the products of their members and other producers, or for the purpose of purchasing supplies and equipment for use by their members or other persons. To qualify for exemption from federal income tax under section 521, a cooperative must operate on a nonprofit basis. Marketing cooperatives must return to their members or other producers the proceeds of sales less necessary marketing expenses on the basis of the quantity or the value of the products furnished by the members or other producers. Purchasing cooperatives must sell the purchased products to their members or others at cost plus necessary expenses. Despite the nonprofit requirement, exempt cooperatives are permitted to pay dividends and to maintain reasonable reserves.

Exempt farmers' cooperatives must satisfy additional operational and ownership requirements. First, they must limit business done with nonmembers. Marketing cooperatives may market the products of nonmembers, but the value of those products may not exceed the value of the member products marketed by the cooperative. Similarly, purchasing cooperatives may purchase supplies and equipment for nonmembers, but the value of those products may not exceed the value of supplies and equipment purchased for members, and the value of purchases made for persons who are neither members nor producers may not exceed 15 percent of the value of all of the cooperative's purchases.

Unlike non-exempt cooperatives, exempt farmers' cooperatives are permitted to issue capital stock to non-members under certain circumstances. Capital stock issued to non-members may only be non-voting preferred stock in which does not permit its owners to participate directly or indirectly in the profits of the association and the dividend rate on which does not exceed the greater of 8 percent or the legal rate of interest permitted by the state of incorporation.

To the extent that an exempt farmers' cooperative complies with the provisions of section 521 of the Code, it may deduct from its gross income most non-patronage distributions it makes to its members, as well as dividends paid with respect to preferred stock owned by non-members. Thus, the exemption under section 521 carries the single level of tax generally available under the Subchapter T for income patronage sources to income from non-patronage sources as well.

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 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) 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. Taxpayer is an organization to which part I of subchapter T applies. It is engaged in the marketing of agricultural or horticultural products (i.e., b, which it markets, and various farm supplies, which it sells to its members).

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 QPAI 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.

Taxpayer does not operate on a pooling basis. Taxpayer purchases b from its members and markets that b. The amount that each member receives when it sells b to Taxpayer for marketing depends upon where, how, and when the member chooses to sell that b to Taxpayer.

Members have a number of options for determining how and when sales are made. As a result, two neighboring farmers delivering the same amount of b to Taxpayer during any year will be paid different amounts for that b depending upon where, when and how they sell the b to Taxpayer. However, all members share in Taxpayer's net earnings from member b operations in proportion to the number of c of b they market through Taxpayer. Those net earnings are distributed after the end of each year in the form of patronage dividends.

The question presented in this ruling is whether the payments made by Taxpayer to members for b qualify as per-unit retain allocations paid in money within the meaning of section 1388(f) of the Code.

Under section 199 of the Code and section 1.199-6 of the regulations, the answer to this question determines who gets to include the b payments in the section 199 computation. If the b payments to members are per-unit retain allocations paid in money, then they should be added-back in Taxpayer's section 199 computation and not included in the members' section 199 computations. If the b payments to members are not per-unit retain allocations paid in money, then they should not be added-back in Taxpayer's section 199 computation, but should be included in the members' section 199 computations. These results are the same whether Taxpayer decides to keep or to pass-through all or a portion of its section 199 deduction.

According to Taxpayer, b marketing cooperatives such as Taxpayer have never thought of their b payments as per-unit retain allocations paid in money. However, Taxpayer's b 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.

The b payments are made in cash so the "paid in money" requirement is met. Taxpayer's b payments also meet all the requirements of the definition of "per-unit retain allocation" contained in section 1388(f) of the Code, 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 b payments to a member are paid "pursuant to an agreement," namely the particular agreement applicable to the method the member uses to determine how and when his or her b is sold to Taxpayer.

Second, Taxpayer's b payments to a member are made "with respect to products marketed for him," namely, the b delivered by the member for marketing by Taxpayer. As described above, Taxpayer markets the b it acquires from members, and members share in Taxpayer's net earnings from its marketing activities in the form of patronage dividends.

Third, the amount of the b 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.

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 b (i.e., that Taxpayer does not pool) does not mean that b 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."

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.

Taxpayer's b payments qualify as per-unit retain allocations within the meaning of section 1388(f) of the Code because they are: (1) distributed with respect to b that Taxpayer markets for its members; (2) the members receive the payments based on the quantity of b delivered; (3) the b payments are determined without reference to Taxpayer's net earnings; (4) the b payments are paid pursuant to a contract with the members establishing the necessary pre-existing agreement and obligation; and (5) the b payments are paid within the payment period of section 1382(d). Such per-unit retains are to be reported in box 3 of Form 1099-PATR, "Taxable Distributions Received From Cooperatives."

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 of the Code. 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 b payments meet the definition of "per-unit retain allocations paid in money." Taxpayer may disregard such payments in determining the amount of its section 199 deduction.

Accordingly, we rule as requested that:

1. Cash advances from Taxpayer to its members in exchange for b products grown in the United States are PURPIMs as defined in section 1382(b)(3) and 1388(f) of the Code; and

2. That such advances are properly included in QPAI and taxable income of Taxpayer solely for purposes of calculating, at the cooperative level, the deduction allowed under section 199 of the Code.

No opinion is expressed or implied regarding the application of any other provision in the Code or regulations. The conclusions set forth in this ruling are limited to b payments made during a year attributable to b which is sold by Taxpayer during the year. No opinion is expressed or implied as to whether b payments made during a year attributable to b which is in inventory at year-end qualify as per-unit retain allocations paid in money.

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)