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LEGEND:

Taxpayer =

State A =

Dear :

This is in response to a request for rulings dated December 16, 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 under the State A Cooperative Law. Taxpayer files a federal income tax return (Form 1120-C) on the basis of a fiscal year ended . Taxpayer's overall method of accounting for federal income tax purposes is the accrual basis.

Taxpayer is a local grain marketing and farm supply cooperative. It is headquartered in State A. It serves farmers located in a **5** county area.

Taxpayer markets grain for its farmer members and others. During its fiscal year ended , Taxpayer's grain sales were approximately $. Principal commodities marketed in were corn ($), soybeans ($), and wheat ($). Taxpayer also marketed some oats ($).

Taxpayer represents that it is organized and operated on a cooperative basis. The State A Cooperative Law applies to organizations "formed or incorporated on a cooperative plan" for a variety of purposes including for the purpose of conducting an "agricultural, dairy, [or] marketing … business." State A Statutes, Section . The State A Cooperative Law requires that a cooperative distribute "[n]et income in excess of dividends on capital stock and additions to reserves … on the basis of patronage." State A Statutes, Section . The statute provides that the distribution shall be made "at least annually." State A Statutes, Section . A distribution may be "in cash, capital stock credits, allocated patronage equities, revolving fund certificates, or its own or other securities." State A Statutes, Section .

Taxpayer's Articles of Incorporation provide that "[t]his cooperative shall be operated on a cooperative basis for the mutual benefit of its members as producers." Articles of Incorporation, Article V. Article VI provides for the sharing of earnings on a cooperative basis:

> "The net income of this cooperative in excess of dividends on equity capital and additions to reserves shall be distributed to members and nonmember patrons annually or more often on the basis of patronage and the records of this cooperative may show the interest of members and nonmember patrons in the reserves. Net income may be accounted for and distributed on the basis of allocation units that may be functional, divisional, departmental, geographic, or otherwise. Net income may be distributed in cash, capital stock credits, allocated patronage equities, revolving fund certificates, securities of this cooperative, other securities, or any combination thereof. Any such allocated equity shall be redeemable only at the option of the Board of Directors. … The foregoing provisions of this Article shall be implemented as more particularly provided in the Bylaws of this cooperative."

The Articles of Incorporation provide that Taxpayer "is organized without capital stock." Article IV. The Articles of Incorporation limit membership in Taxpayer to "producers of agricultural product (individuals, firms, partnerships, corporations, family farm corporations or cooperatives)" and provide that the "Bylaws of this cooperative may further restrict membership in this cooperative." Article V. Article V provides that the "voting rights of the members of the cooperative shall be equal, and no member shall have more than one vote upon each matter submitted to a vote at a meeting of the members as more specifically provided for in the Bylaws."

Article VII of Taxpayer's Bylaws provides a detailed description of how Taxpayer computes and pays patronage refunds. Article VII, Section 7.01 of the Bylaws repeats Taxpayer's obligation to distribute its earnings as patronage dividends:

> "This cooperative shall be operated upon the cooperative basis in carrying out its business within the scope of the powers and purposes defined in the Articles of Incorporation. Accordingly, the net income of this cooperative in excess of amounts credited by the Board of Directors to capital reserves and amounts of dividends, if any, paid with respect to equity capital shall be accounted for and distributed annually on the basis of allocation units (as authorized by the Board of Directors) as provided in this Bylaw."

Article VII, Section 7.03 of the Bylaws permits Taxpayer to pay patronage dividends based upon allocation units:

> "Allocation units may be established by the Board of Directors on a reasonable and equitable basis and they may be functional, divisional, departmental, geographic, or otherwise; provided, that if the Board of Directors establishes a separate business group within this cooperative, the separate business group shall be accounted for as a separate allocation unit."

Taxpayer allocates patronage dividends upon the basis of six allocation units. For grain, Taxpayer has three allocations units, one for each of the principal commodities Taxpayer handles (corn, soybeans and wheat). The patronage profits of each grain unit are allocated based upon bushels of grain marketed through that unit by members and other patrons eligible to share in patronage dividends. For supplies, Taxpayer has three allocation units – fertilizer, agricultural chemicals and seed. The patronage profits of each supplies unit are allocated based upon dollars of purchases through that unit by members and other patrons eligible to share in patronage dividends.

Article VII, Section 7.07(b) of the Bylaws authorizes Taxpayer to pay patronage dividends in "cash, allocated patronage equities, revolving fund certificates, securities of this cooperative, other securities, or any combination thereof designated by the Board of Directors…" Patronage dividends are normally paid in a combination of cash and revolving fund certificates. In the past, the revolving fund certificates distributed by Taxpayer as part of its patronage dividends have been "qualified written notices of allocation" as defined in subchapter T of the Code.

This ruling relates to Taxpayer's grain marketing activities. Taxpayer operates grain elevators located in State A.

Taxpayer sells grain to livestock producers for feed, to grain processors to be used to produce ethanol, high-fructose corn sweetener and other products, to soybean processors to be crushed and sold as soybean meal, oil and other further refined products, and to others for resale, both domestically and in the export market. Taxpayer's grain business consists of buying grain from patrons, handling and storing

the grain at its elevators, and then selling the grain to terminal grain elevators, grain processors, feed lots, grain exporters and others.

The issue in this ruling relates to the characterization for purposes of subchapter T of the Code and section 199 of payments (referred to in this ruling as "grain payments") that Taxpayer makes to members and other patrons eligible to share in patronage dividends when it acquires their grain for marketing on a patronage basis. For purposes of this ruling, "grain payments" do not include any amounts paid to persons not entitled to share in patronage dividends. Almost all of Taxpayer's grain business is done with members and other patrons eligible to share in patronage dividends. For purposes of this ruling, the term "grain payments" also does not include patronage dividends paid to members and other patrons of Taxpayer with respect to grain marketed for them.

Taxpayer does not operate on a pooling basis. Thus, the patrons of Taxpayer do not commit to deliver all of the grain they grow from specified acreage to Taxpayer to be pooled with the grain of other patrons as they typically would be if Taxpayer operated like a pooling cooperative. Commodity price risk does not shift from Taxpayer's patrons to a pool at the time of harvest as it would if Taxpayer pooled the grain of its patrons, but rather remains with patrons until they decide to sell their grain to Taxpayer for marketing. All of Taxpayer's marketing proceeds are not shared equally on the basis of patronage and distributed in the form of harvest advances and progress payments with a final settlement after the pool closes as they would be if Taxpayer pooled.

Taxpayer pays each patron a market price for his or her grain. That market price is determined without regard to the actual net proceeds from marketing grain. What that market price is depends upon where, when and how a patron chooses to sell his or her grain to Taxpayer. Payments are made in cash (by check) and occur throughout the year as patrons sell grain to Taxpayer for marketing and are paid pursuant to the terms of their grain contracts.

After purchasing grain from members, Taxpayer then markets each patron's grain along with the grain of all of its other patrons in the manner that it judges will produce the best return. After year end, when net earnings for the year have been determined, Taxpayer pays a patronage dividend to its members and other patrons eligible to share in patronage dividends with respect to the grain they market through Taxpayer.

Farmers historically have retained the decision of when and how to sell their grain and to choose whether to sell their grain to a cooperative for marketing on a patronage basis or to a commercial grain company. Farmers have a variety of alternatives when they sell their grain to Taxpayer. The choices are similar to those offered farmers by commercial grain companies, though commercial grain companies do not market grain on a patronage basis and do not pay patronage dividends.

The basic choices available to a farmer selling grain to Taxpayer for marketing on a cooperative basis are: (i) to sell the grain for Taxpayer's current cash bid price, (ii) to sell the grain to Taxpayer using a forward contract, and (iii) to sell the grain to Taxpayer using a deferred price or a deferred payment contract. Under each of these basic choices, there are additional options available to farmers.

One way for a farmer to sell grain to Taxpayer for marketing is to sell the grain to Taxpayer and be paid the cash bid price. Many farmers sell grain to Taxpayer on this basis. Typically a country elevator's cash bid price for a commodity is the nearby futures price in a specified reference market where the commodity is actively traded (e.g., the Chicago Board of Trade or the Minneapolis Grain Exchange) plus or minus a fixed spread (referred to as the "basis") set from time to time by the elevator based upon local market conditions. Thus, the cash bid price at a country elevator reflects the condition of the overall market for grain (the futures price) and the condition of the local market for grain (the basis). An elevator's cash bid price changes during the course of each day as the reference futures price fluctuates. It also changes (though not as often) as the elevator adjusts the basis.

The bid price schedule at country elevators changes from hour to hour and day to day. A farmer can deliver and sell grain to Taxpayer at the cash bid price at the time of harvest, delivering the grain directly from the field. However, it usually is not advantageous for farmers to sell then since prices often are lowest at harvest. Many farmers have the capacity to store grain on their farm and so can wait until later, when they think that the cash bid price is right, to deliver and sell their grain to Taxpayer. Other farmers deliver grain to Taxpayer for storage, not for immediate sale. The farmers retain ownership of the grain in the elevator and pay storage fees to Taxpayer. Later, when a farmer believes the cash bid price is right, he or she can sell the grain to Taxpayer for marketing on a cooperative basis.

Taxpayer gives farmers the option of offering their grain for sale to Taxpayer at a price fixed by the farmer. This offer, which is open for a period specified in the contract, may be cancelled at any time by the farmer prior to the time it has been accepted by Taxpayer. If Taxpayer accepts the offer, the farmer is obligated to deliver the grain (or transfers title if the grain is in storage) at the cash price specified in the offer. The form of contract is referred to by Taxpayer as a "Confirmation of Grain Offer." This option is not much used.

A farmer has the option of entering into a forward contract to sell his or her grain to Taxpayer. Forward contracts call for delivery of a specified quantity and quality of grain, at a specified location, during a specified time period. Forward contracts can be entered into before the grain is planted, while it is growing or after harvest while the grain is being stored on the farm or in an elevator. Forward contracts can be priced in a variety of ways.

Many contracts provide for a fixed price, sometimes referred to as a "flat" price. Farmers interested in entering into a forward contract with Taxpayer can determine the fixed price Taxpayer is willing to pay at any time at any of its locations for delivery at various times in the future from Taxpayer's bid schedules for grain for future delivery.

Typically a country elevator's bid price for future delivery is determined in a manner similar to the way the cash bid price is determined. However, when the bid price is for future delivery, it is based upon the nearby futures price for the time specified for delivery plus or minus the basis set by the country elevator for that delivery month. The bid price for future delivery changes during the course of each day as the specified reference price fluctuates. It also changes as the country elevator adjusts its basis.

Farmers also can enter into forward contracts where the pricing is left open for future determination. For instance, the contracts may fix the basis and leave the futures price open, to be determined based upon the futures price at the time chosen by the farmer before a specified date in the future. Alternatively, the contracts may specify the futures price and leave the basis open, to be determined based upon the elevator's basis for delivery during the future month at the time chosen by the farmer before a specified date in the future. Some cooperatives use contracts which specify a minimum price that will be paid for the member's grain, giving the farmer the option to fix the price before a specified date in the future based upon a reference futures price, leaving open the possibility that a price greater than the minimum price will be paid if futures prices go up.

Farmers have the option to deliver grain to Taxpayer, leaving the determination of the price partly or wholly open. Contracts of this sort are called by various names – deferred price contracts, delayed price contracts, credit-sale contracts, etc. Under a deferred price contract, ownership of the grain passes from the farmer to Taxpayer at the time of delivery. Farmers are given the opportunity to wait until later to price the grain. When the farmer chooses to price the contract, the cooperative's then current bid price is used to fill the open price term. Once the price is determined the farmer member is paid.

Some farmers prefer to sell their grain to Taxpayer on a deferred payment basis. Grain sold on that basis might be delivered in October, the price set at that time, but with payment to be made in January. Ownership of the grain passes to Taxpayer when the grain is delivered. About bushels of grain were purchased by Taxpayer during fiscal using deferred payment contracts.

The variety of options available to farmers for selling their grain to Taxpayer and other grain companies provide farmers with a great deal of flexibility. Farmers can lock in prices for their crops (even before they are planted or while they are growing) at any time if they think that the price is right by using flat price forward contracts. Some farmers prefer to do so after they can estimate the costs of production to lock in a

reasonable margin. If a farmer is happy with the futures price, but not the basis, the farmer can enter into a forward contract that leaves the basis open. If a farmer is happy with the basis, but not the futures price, the farmer can enter into a forward contract that leaves the futures price open. If a farmer wants the assurance of a minimum price, the farmer can enter into a forward contract that specifies a minimum price, but leaves final pricing open. Such a contract can result in a higher price if the futures price increases, or a guaranteed minimum price (albeit somewhat lower than the farmer could otherwise have obtained) if the futures price does not increase.

If farmers think that the cash price is low at the time of harvest, they can harvest and store their crops while waiting for the price to improve. Alternatively, they can deliver the crops and enter into a deferred price contract.

Farmers with grain in storage on the farm or at the cooperative can extend an offer to the cooperative, open for a specified period of time, to sell grain at a price fixed by the farmer in the offer. Alternatively, farmers can sell grain that is in storage at any time at the cooperative's cash bid price.

These choices and others described above are available to all farmers marketing their grain on a cooperative basis through Taxpayer. Because of these choices, two neighbors that market the same quantity and quality of a particular kind of grain through Taxpayer during any year will receive different grain payments depending upon where, when and how they sell their grain to Taxpayer. However, they will receive the same patronage dividends.

For the fiscal year ended , Taxpayer made grain payments to members and other patrons eligible to share in patronage dividends of approximately $. Taxpayer anticipates that it will be paying patronage dividends to members and other patrons with respect to their grain of approximately $. The patronage dividends will be paid in cash and qualified written notices of allocation (revolving fund certificates).

Taxpayer has treated grain payments made in cash to members and other patrons eligible to share in patronage dividends as "purchases" for tax purposes and reported them on Schedule A, Line 2 of its Form 1120-C. Taxpayer has not reported the grain payments made in cash 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 the patronage dividends paid to members and other patrons as a patronage dividend paid in money and qualified written notices of allocation on Schedule H, line 3a of its Form 1120-C.

Because of this reporting, grain payments paid in cash have entered into the determination of Taxpayer's cost of goods sold for tax purposes. As is customary in the grain business, Taxpayer values its grain inventories at year end at market for financial statement and tax purposes.

Taxpayer did not add back grain payments in its section 199 computations for prior years. Taxpayer did not pass any portion of its section 199 deduction through to its members or other patrons in prior years.

Recent developments have caused Taxpayer to reconsider how it should treat its grain payments for purposes of its section 199 computation. For reasons described below, Taxpayer is seeking confirmation that all grain payments to members and other patrons eligible to share in patronage dividends that are paid in cash should be classified as “per-unit retain allocations paid in money.”

In prior years, Taxpayer has disregarded patronage dividends paid in cash and qualified written notices of allocation for purposes of determining qualified production activities income and taxable income for section 199 purposes. Taxpayer plans to begin disregarding grain payments made to members and other patrons eligible to share in patronage dividends for purposes of computing its qualified production activities income and its taxable income. Taxpayer also is considering passing through to members all or a portion of its section 199 deduction.

Based on the foregoing, Taxpayer requests the following rulings:

1. Grain payments to members and other patrons eligible to share in patronage dividends 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 activities 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 grain payments to members and other patrons eligible to share in patronage dividends.

Nonexempt subchapter T cooperatives are permitted to exclude or deduct distributions to patrons that qualify as per-unit retain allocations or patronage dividends, provided the distributions other 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., grain).

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 purposes of section 199. 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. As a specified agricultural or horticultural cooperative, Taxpayer is entitled to the benefit of section 199(d)(3)(C) and section 1.199-6(c), which permit such cooperatives to disregard deductions under section 1382(b) and (c)[1] for purposes of computing QPAI and taxable income for purposes of section 199. 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 grain from patrons and markets that grain. The amount that each patron receives when he or she sells grain to Taxpayer for marketing depends upon where, how, and when the patron chooses to sell that grain to Taxpayer. Patrons are not required to deliver their grain to Taxpayer. They are free to sell as little or as much of their grain to Taxpayer as they choose.

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1. Section 1382(c) of the Code permits section 521 cooperatives to claim deductions for certain dividends paid on preferred stock and for patronage based distributions of nonpatronage income. Taxpayer is a nonexempt subchapter T cooperative and does not claim any deductions under section 1382(c).

Patrons have a number of options for determining how and when sales are made. As a result, two neighbors delivering the same amount of grain to Taxpayer during any year will be paid different amounts for that grain depending upon where, when and how they sell the grain to Taxpayer. However, all patrons share in Taxpayer's net earnings from grain operations in proportion to the number of bushels of grain they market through Taxpayer. Those net earnings are distributed after the end of each year in the form of patronage dividends paid in cash and qualified written notices of allocation (revolving capital).

The question presented in Taxpayer's ruling request is whether the grain payments made by Taxpayer to patrons for grain 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 grain payments in the section 199 computation. If the grain payments to patrons 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 patrons' section 199 computations. If the grain payments to patrons 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 patrons' 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.

Grain marketing cooperatives like Taxpayer have never thought of their grain payments as per-unit retain allocations paid in money. However, Taxpayer's grain payments appear to 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 grain payments are made in cash so the "paid in money" requirement is met.

Taxpayer's grain 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 grain payments to a patron are paid "pursuant to an agreement," namely the particular agreement applicable to the method the patron uses to determine how and when his or her grain is sold to Taxpayer.

Second, Taxpayer's grain payments to a patron are made "with respect to products marketed for him," namely, the grain delivered by the member or other patron eligible to share in patronage dividends for marketing by Taxpayer. As described above, Taxpayer markets the grain it acquires from members and other patrons, and

members and other patrons share in Taxpayer’s net earnings from its marketing activities in the form of patronage dividends.

Third, the amount of the grain payments to each patron “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 and other patrons eligible to share in patronage dividends do not receive the same payments for their grain (i.e., that Taxpayer does not pool) does not mean that grain 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.”

Historically, Taxpayer has treated its grain payments as "purchases," not as "per-unit retain allocations paid in money." However, how the payments have been reported should not obscure what they really are.

Whether or not Taxpayer is pooling is a moot issue for purpose of this ruling because its grain 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.

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 grain 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 grain 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. Grain payments to members and other patrons eligible to share in patronage dividends 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 activities 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 grain payments to members and other patrons eligible to share in patronage dividends.

The conclusions set forth in this ruling address only purchases that are per-unit retain allocations paid in money as they relate to grain marketed by the cooperative during the taxable year and does not apply to purchases of grain that remain in inventory at year end. 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: