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LEGEND:

Taxpayer	=	
State A	=	
Region	=	
b	=	
Corp A	=	

Dear

This is in response to a request for rulings dated January 26, 2010, 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 Cooperative Marketing Act of State A. Taxpayer serves farmers located in the Region. Taxpayer was formed in as a result of the merger of two farmers' cooperatives. Corp A was the survivor in the merger and it changed its name to Taxpayer.

Farmers in the Region raise grain and . Taxpayer markets these crops. During its fiscal year ended , Taxpayer's grain sales were approximately $. Principal grains marketed were wheat and barley. Taxpayer's sales were approximately $ Principal b marketed were . Taxpayer also processes and sells seed. During , Taxpayer's seed sales totaled approximately $. In addition, Taxpayer sells lumber, hardware and other miscellaneous supplies (sales of these amounted to approximately $). Taxpayer's "members" are producers of grain and b who do business with it. During , Taxpayer had approximately members.

Taxpayer is organized and operated on a cooperative basis. The State A Cooperative Marketing Act applies to "any association operating as an agricultural cooperative." . According to the State A Cooperative Marketing Act, associations organized under the Act "shall be deemed nonprofit, inasmuch as they are not organized to make profits for themselves, as such, or for their members, as such, but only for their members as producers**."** .

The State A Cooperative Marketing Act provides:

> "An association may be organized to engage in any activity in connection with the production, marketing or selling of the agricultural products of its members, or with the harvesting, preserving, drying, processing, canning, packing, storing, handling, shipping or utilization thereof, or the manufacturing or marketing of the by-products thereof; or in connection with the purchasing, manufacturing, selling or supplying to its members of machinery, equipment or supplies; or in the financing of the above enumerated activities; or in any one or more of the activities specified herein." .

Taxpayer's Articles of Incorporation state that Taxpayer "is organized for the purposes of engaging on a nonprofit, cooperative basis as agent for its members in any business trade or activity which may lawfully be conducted by a cooperative marketing association" organized under the State A Cooperative Marketing Act. Article 4, Section 1. Taxpayer's By-laws repeat this, stating that Taxpayer "shall, at all times, be operated on a cooperative basis for the mutual benefits of its members." Article IX, Section 1.

The Articles of Incorporation provide that Taxpayer "is organized without capital stock." Article 5, Section 1. They further state that "[e]ligibility for membership shall be as defined in the Association's By-laws." Article 5, Section 2(a). Taxpayer's By-laws limit membership to producers of agricultural products. By-Laws, Article IV, Section 1. The Articles of Incorporation provide that "[v]oting power of the members of the

Association shall be equal and each member shall have one vote only." Article 5, Section 2(c).

Taxpayer allocates and distributes its earnings each year from business done with or for members in the form of patronage dividends. Article IX of Taxpayer's By-laws describes how Taxpayer computes and pays patronage refunds. In pertinent part, Article IX, Section 3 provides:

> "Section 3. Obligation to Allocate Net Margins. Each business patronage transaction between the Association and its members in each department (with the exception of hardware and petroleum effective commencing) shall be subject to and include as a part of its terms, the obligation of the Association to allocate as patronage dividends to such members its net margins for such departments for each fiscal year … to the extent attributable to the business patronage by such members for such period. All such net margins of the Association from business patronage by its members shall be allocated and credited to the accounts of such members on a basis proportionate to the value of their individual business patronage with the Association …."

Taxpayer allocates patronage dividends on the basis of several departments or allocation units. For grain, Taxpayer has seven allocation units, three for wheat, three for barley and one for other grain. For each of the wheat allocation units, patronage dividends are allocated based upon bushels of wheat marketed. For the three barley and one other grain allocation units, patronage dividends are allocated based upon tons marketed. For b, Taxpayer has one allocation unit, which it refers to as "processing," since Taxpayer processes (sorts, cleans, bags or containerizes) the b it markets. Patronage for that unit is based on hundredweights of b marketed. Taxpayer has a separate allocation unit for seed, which bases the patronage dividend allocation on dollars of seed purchases by members. Finally, Taxpayer has a separate allocation unit for handling and storage of grain and b, with patronage dividends allocated based on dollars of storage and handling fees paid by each member. Taxpayer conducts its lumber, hardware and miscellaneous supply business on a nonpatronage basis.

Article IX, Section 4 of the By-laws authorizes Taxpayer to pay patronage dividends in cash and written notices of allocation (referred to by Taxpayer as "book credits"), which may be qualified or nonqualified. The By-laws direct Taxpayer to retain any net margins attributable to business done with nonmembers and to any nonpatronage business (including any extraneous business with the federal government or its agencies). Article IX, Sections 10 and 11. Thus, Taxpayer does not pay patronage dividends to nonmembers. The amount of business conducted with nonmembers varies from year to year. In recent years, nonmember business has constituted approximately percent of Taxpayer's marketing business.

Taxpayer's By-laws address what is to be done in the event of a loss. Article IX, Section 12. In general, the By-laws permit losses to be netted between allocation units subject to some limitations. The By-laws further provide that overall losses "shall be allocated to all members on the same basis as net margins are distributable hereunder." Article IX, Section 12(a)(1). They then provide that losses allocated to a member may be recovered by offset against capital credits of the member "or by any other method of collection." Article IX, Section 12(a)(1).

This ruling relates to Taxpayer's grain and b marketing activities. Taxpayer conducts its grain and marketing through a network of facilities in locations strategically situated in Region. Taxpayer's facilities have the capacity to store over million bushels of grain and b.

Much of the grain and some of the b that Taxpayer markets is destined for the bulk export market. Taxpayer ships grain and b from its elevators to specialty markets, i.e., markets not focused on bulk shipments, but rather on shipments of grain meeting strict commercial contract specifications for quality, production, handling and packaging. Crops sold into specialty markets often command a premium over what is paid for crops sold as bulk commodities.

Taxpayer's patronage grain and b business consists of buying grain and b from members, handling and storing the grain and b at its elevators, and selling the grain and b to customers. The issue in this ruling relates to the characterization for purposes of subchapter T of the Code and section 199 of the amounts (referred to in this ruling as "crop payments") that Taxpayer pays its members for their grain and b when it acquires those for marketing on a patronage basis. For purposes of this ruling, the term "crop payments" does not include any amounts paid to persons not entitled to share in patronage dividends. For purposes of this ruling, the term "crop payments" also does not include patronage dividends paid to members of Taxpayer with respect to grain and b marketed for them.

Taxpayer does not operate on a pooling basis. Thus, 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. Commodity price risk does not shift from Taxpayer's members to a pool at the time of harvest. Rather, it remains with members until they decide to sell their grain and b to Taxpayer for marketing.

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

After purchasing grain and b from members, Taxpayer then markets each member's crops along with the crops of all of its other members in the manner that it judges will produce the best return. After year end, when net earnings for the year have been determined (after treating amounts paid to members for their crops as a cost of the crops), Taxpayer pays a patronage dividend to its members with respect to the grain and b they market through Taxpayer.

Grain farmers in the United States historically have retained the decision of to whom, when and how to sell their grain. The basic choices available to a farmer selling grain and b 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 fixed price forward contract, and (iii) to sell the grain to Taxpayer using a deferred price contract. These 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.

One way for a farmer to sell grain or b to Taxpayer for marketing is to sell the crops to Taxpayer and be paid the cash bid price. The cash bid prices are gross prices. The actual amount of the checks paid to growers for their grain is the gross amount less various charges.

Some of the charges are adjustments for the quality of the grain, which can be either positive or negative. The cash bid price assumes that the grain will meet certain quality standards. If the grain exceeds those standards, a premium may be paid. If the grain does not meet the standards, a discount may be applied.

Other charges are for services rendered by Taxpayer for the member in connection with marketing the grain. For instance, to help defray the cost of its operations, Taxpayer charges members a handling fee of per bushel. There is also a charge for the cost of transporting the grain to , since the price is a delivered price. In addition, if a farmer has stored his crop at one of Taxpayer's elevators before selling it to Taxpayer, a storage charge is deducted. If the member owes Taxpayer money for seed and supplies purchased from Taxpayer, that amount is also shown as a deduction in arriving at a net amount due the member. The net amount due to a producer for b is determined in the same manner as for grain, except that there is no charge for shipping the grain to .

Taxpayer's bid price schedule changes from hour to hour and day to day. A farmer can deliver and sell grain and b to Taxpayer at the cash bid price at the time of harvest, delivering the crops 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 crops on their farm and so can wait until later, when they think that the cash bid price is right, to deliver and sell their crops to Taxpayer.

Other farmers deliver their crops to Taxpayer for storage, not for immediate sale. The farmers retain ownership of the crops 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 crops to Taxpayer for marketing on a cooperative basis.

A farmer has the option of entering into a fixed price forward contract to sell his or her wheat or some other crops to Taxpayer. Forward contracts call for delivery of a specified quantity and quality of crops, at a specified location, during a specified time period. Forward contracts can be entered into before the crop is planted, while it is growing or after harvest while the crop is being stored on the farm or in an elevator. The most common forward contract used by Taxpayer calls for a fixed price.

Farmers interested in entering into a forward contract with Taxpayer for wheat can determine the fixed price Taxpayer is willing to pay for delivery at various times in the future from Taxpayer's bid schedules for grain. Taxpayer is able to offer fixed price forward contracts for wheat because it can hedge its price exposure by entering into corresponding fixed price forward contracts with its customers or appropriate futures contracts on an exchange.

Taxpayer offers farmers the opportunity to enter into a fixed price new crop contract in the spring before planting for some crops other than wheat. In , Taxpayer offered fixed price new crop contracts for

barley. Since the ability of Taxpayer to offer such fixed price contract depends upon Taxpayer in turn having fixed price contracts from customers (there are no futures markets for these crops), new crop contracts are not offered for all crops and the contracts that are available are offered on a first come, first served basis.

Farmers also can enter into forward contracts for wheat where the pricing is left partly open for future determination. In this contract, one element of the price, the futures price for future delivery has been determined, but the basis has not been determined. The basis under this contract will be determined on the date specified by the farmer (but no later than). The basis referred to in this contract is the basis. These contracts are not commonly used.

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 or at the time set in the agreement, with payment at a later date.

The options available to farmers for selling their grain and b to Taxpayer provide members with a reasonable amount of flexibility. Farmers can lock in prices for their wheat (even before the wheat is planted or while it is growing) at any time if they think that the price is right by using fixed price forward contracts. This option is also available for some of the other crops through the use of fixed price new crop contracts. Some farmers prefer to enter into fixed price contracts after they can estimate the costs of production to lock in a reasonable margin. If a farmer is happy with the futures price of wheat, but not the basis, the farmer can enter into a forward contract that leaves the basis open but fixes the futures component of the price.

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. Farmers with grain in storage on the farm or at Taxpayer can then sell grain that is in storage at any time at the cooperative's cash bid price.

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

For the fiscal year ended , Taxpayer made crop payments to members of approximately $ million. Taxpayer paid patronage dividends to members with respect to their crop sales, seed purchases and warehouse handling and storage of approximately $ million. The patronage dividends were paid 40 percent in cash and 60 percent in qualified written notices of allocation (book credits).

Taxpayer has not yet filed its tax return for the first year after the merger (the fiscal year ended). However, Taxpayer is the legal successor to Corp A, the entity that was the survivor in the merger. Corp A historically has treated crop payments made in cash to members as "purchases" for tax purposes and reported them on Schedule A, Line 2 of its Form 1120-C.

Corp A has not treated the crop 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 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, crop payments paid in cash historically entered into the determination for tax purposes of Corp A's cost of goods sold for tax purposes. As is customary in the grain business, Corp A has valued its crop inventories at year end at market for financial statement and tax purposes.

Corp A has not added back crop payments in its section 199 computations for prior years. Corp A did not pass any portion of its section 199 deduction through to its members in prior years.

Recent developments have caused Taxpayer to reconsider how it should treat its crop payments for purposes of its section 199 computation. For reasons described below, Taxpayer is seeking confirmation that all crop payments to members that are paid in cash should be classified as “per-unit retain allocations paid in money.” Taxpayer plans to disregard crop payments made to members for purposes of its section 199 computation. Taxpayer also is considering passing through to members all or a portion of its section 199 deduction.

Based on the forgoing Taxpayer requests the following rulings:

1. Crop payments to members 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 crop payments to members.

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, 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) 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 and b from members and markets those crops. The amount that each member receives when he or she sells grain or b to Taxpayer for marketing depends upon where, how, and when the patron chooses to sell that grain or b to Taxpayer.

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 or b to Taxpayer during any year will be paid different amounts for that grain or b depending upon where, when and how they sell the grain and b to Taxpayer. However, all patrons share in Taxpayer’s net earnings from marketing operations in proportion to the quantity of crops 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 (book credits).

The question presented by the ruling request is whether the crop payments made by Taxpayer to patrons for grain or 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 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.

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

Taxpayer's crop 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 crop 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 grain is sold to Taxpayer.

Second, Taxpayer's crop payments to a member are made "with respect to products marketed for him," namely, the grain and b delivered by the member for marketing by Taxpayer. As described above, Taxpayer markets the grain and 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 crop 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 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 crop 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 and b 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 and b 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 crop payments to members meet the definition of "per-unit retain allocations paid in money." The per-unit retains must be treated as such for all purposes of the Code and are reported in box 3 of Form 1099-PATR, "Taxable Distributions Received From Cooperatives." If properly treated as per-unit retain allocations paid in money, then Taxpayer will be entitled to disregard such payments in determining the amount of its section 199 deduction.

We note that payments to nonmembers who are not eligible to share in patronage dividends (i.e., those with whom the Taxpayer does not operate on a cooperative basis with) do not constitute per-unit retains paid in money within the meaning of section 1382(b)(3) of the Code and, accordingly, are treated exclusively as purchases in the cost of goods sold mechanism.

Accordingly, we rule as requested that:

1. Crop payments to members 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 crop payments to members.

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

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