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Legend

Taxpayer =

State A =

Dear :

This is in response to a request for rulings dated February 17, 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 State A Cooperative Law. Taxpayer is a local grain marketing and farm supply cooperative. Headquartered in State A, Taxpayer serves farmers through a network of facilities located in a - county area.

Taxpayer was formed as a result of the consolidation, effective , of two State A cooperatives – , headquartered in , State A and , headquartered in , State A. Since the two cooperatives consolidated, rather than merged, Taxpayer is a new cooperative corporation for federal income tax purposes and thus has a new taxpayer identification number. Taxpayer is the legal successor to both and , and continues the businesses each conducted. Together, and are sometimes referred to in this ruling as "Taxpayer's predecessors."

Taxpayer markets grain for its farmer members and for other patrons. During the fiscal year ended (the year before the consolidation), the grain sales

of Taxpayer's predecessors totaled approximately $ . Principal commodities marketed in were corn, soybeans, and wheat. Taxpayer also provides its members and patrons with a broad range of supplies used in farming – including principally agronomy products (fertilizer, farm chemicals, seed), energy products (propane, diesel fuel, gasoline, etc.), feed and general farm supplies. During , the farm supply sales of Taxpayer's predecessors totaled approximately $ .

Taxpayer's "members" include voting members and nonvoting members. Voting members are producers (i.e., farmers) and farmer's cooperatives that do business with Taxpayer. Nonvoting members are other persons interested in doing business with Taxpayer on a patronage basis [Note: although Taxpayer calls one class nonvoting "members," they are in reality "patrons" within the meaning of section 1.1388-1(e) of the Income Tax Regulations because "member" is defined in section 1.1388-1(c)(3)(ii)(c) to mean a person who is entitled to participate in the management of the cooperative organization]. Taxpayer currently has approximately voting members and nonvoting members. Taxpayer pays patronage dividends to both voting members and nonvoting members (other participating patrons). Taxpayer does not pay patronage dividends to nonmembers.

Taxpayer is organized and operated on a cooperative basis. State A has a special law for the incorporation of cooperative associations known as the "State A Cooperative Law." State A Revised Code, Chapter . The State A Cooperative Law provides that associations organized under the act "shall be corporations that are deemed nonprofit because they are not organized for the purpose of making a profit for themselves as such, or for the purpose of making a profit for their members as such, but for their members as patrons." Section . The State A Cooperative Law provides that cooperative associations shall distribute their earnings on a patronage basis:

> "(A) An association may pay dividends annually on its capital stock. All its other net income from business with or for members and other eligible patrons, less reserves which shall be provided for in the bylaws or other written agreements, shall be distributed to its members and other eligible patrons on the basis of patronage as provided in the bylaws or other written agreements.…" ( ).

Taxpayer's Articles of Incorporation provide that "[t]he Association is a corporation organized as a cooperative association under Chapter of the [State A] Revised Code (the '[Taxpayer] Cooperative Law')." Section 3.2. They describe Taxpayer's purpose:

> "3.1 **PURPOSE**. The primary purpose of the Association is to associate Producers and others to provide them economic benefit through joint

> action in procuring supplies, services and equipment and in marketing products they produce. The specific purpose of the Association and the general nature of its business is to market grain, procure crop and livestock production inputs, distribute petroleum fuels, and to provide related services, supplies and equipment for its Members and other persons. The Association may engage in any other lawful business or activity for which an association may be organized under the [State A] Cooperative Law." (Section 3.1).

Taxpayer is organized with capital stock. It has one class of common stock and six classes of preferred stock (A Preferred, B Preferred, C Preferred, D Preferred, E Preferred and F Preferred). Section 4.1. No shares of F Preferred are issued and outstanding.

The common stock and the D Preferred are membership stock. The common stock has a par value of $100 per share and the D Preferred has a par value of $50 per share. Section 4.1. Neither is entitled to receive dividends. Section 4.5(E). Each voting member owns one share of common stock, and each nonvoting member owns one share of D Preferred. Section 5.1(A)(4) and (B)(3).

Voting membership is limited to producers and farmers' cooperatives. Sections 4.2(A) and 5.1(A). For this purpose:

> "'Producer' means a person engaged in the production of agricultural products for the market, including lessors of property used for the production of agricultural products for the market who received as rent part of the agricultural product. 'Cooperative" means a Producer-controlled entity that is operated on a cooperative basis." (Section 4.2(A)).

Other persons who are interested in actively patronizing Taxpayer are eligible to be nonvoting members. Section 5.1(B).

The Articles of Incorporation provide that only voting members are entitled to vote and that each voting member has one vote:

> "5.3 **VOTING**. The Voting Members exercise all of the voting control of the Association. Each Voting Member is entitled to one vote on any matter submitted to a vote of the Members. Membership or ownership of capital stock or other equity interests in the Association does not otherwise confer upon the holder any voting rights in the Association.…" (Section 5.3).

The other classes of preferred stock were created to be exchanged in the consolidation for comparable stock in each of Taxpayer's predecessors. The par value

and dividend rights of each class of preferred stock are specified in the Articles of Incorporation. Sections 4.1 and 4.5. A Preferred ($100 par value) is entitled to a non-cumulative dividend of not less than 6 percent and not more than 10 percent per annum. B Preferred ($50 par value) is entitled to a noncumulative dividend of not less than 4 percent and not more than 8 percent per annum. C Preferred ($100 par value) is entitled to noncumulative 6 percent dividends. D Preferred ($50 par value) and E Preferred ($12.50 par value) are not entitled to dividends. F Preferred ($1,000 par value) is issuable in series, and each series is entitled to a cumulative annual dividend not in excess of 8 percent per annum. After the consolidation, the par value of the outstanding dividend-bearing preferred shares (A Preferred, B Preferred and C Preferred) was $ , and the maximum annual dividend payable was approximately $ .

Taxpayer is also authorized to issue Capital Credits. Taxpayer issued Capital Credits in exchange for equity credits and letters of advice issued by Taxpayer's predecessors as part of their patronage dividends. Taxpayer plans to use Capital Credits as part of its patronage dividends. Capital Credits provide a significant source of capital used to finance Taxpayer's business. Section 4.4. As of (after the consolidation occurred), the stated dollar amount of outstanding Capital Credits was $ .

Taxpayer's Articles of Incorporation provide that its net earnings shall be distributed on a cooperative basis as provided in its Bylaws:

> "4.9 **PATRONAGE REFUNDS**. The Net Margins (savings) of the Association in excess of Association Net Margins must be distributed annually to the Association's Patrons as Patronage Refunds on the basis of Patronage Transactions. The calculation, allocation, and distribution of Net Margins must be defined and provided for in the Bylaws." (Section 4.9).

Article 7 of Taxpayer's Bylaws provides a detailed description of how Taxpayer computes and pays patronage refunds. That computation begins with a determination of net margins from all of Taxpayer's business (patronage and nonpatronage) for the fiscal year. Section 7.3. Then, Taxpayer is required to deduct (i) an amount fixed before the beginning of the year for reasonable reserves necessary or desirable to insure solvency and financial stability of the association, (ii) the amount declared by the Board of Directors as dividends on the preferred stock, and (iii) an amount sufficient to pay Taxpayer's taxes. Section 7.4(A)(1), (2) and (3). Amounts held back are subtracted out of net margins from nonpatronage sources, and, only if nonpatronage net margins are not sufficient, are they subtracted from net margins from patronage sources. Section 7.4(A)(4). If earnings from nonpatronage sources exceed the amounts required to be retained, then any excess nonpatronage earnings are set aside

in the capital reserve. Section 7.4(A)(4). Taxpayer refers to the amounts required to be retained for reserves, dividends and taxes as the "Association Net Margins."

Taxpayer's Bylaws then provide:

> "(B) **Patronage Refunds**. The balance of Net Margins after deduction of the Association Net Margins shall be the Patrons Net Margins. The Patrons Net Margins belong to the Patrons and must be allocated to the Patrons on the basis of their Patronage Transactions. These allocated amounts are Patronage Refunds due and distributable to the Patrons as provided in these Bylaws.…" (Section 7.4(B)).

This section of the Bylaws goes on to provide that Taxpayer may pay patronage dividends based upon allocation units:

> "Patronage Refunds may be allocated on the basis of Patronage Transactions and the Net Margins that result from the operations of divisions or departments of the Association as the Board considers fair to the Patrons." (Section 7.4(B)).

Since it is newly formed, Taxpayer has not yet paid any patronage dividends to its members. Taxpayer intends to allocate patronage dividends upon the basis of four allocation units – feed, energy, agronomy and grain. Patrons Net Margins attributable to the grain allocation unit are allocated among members marketing their grain through Taxpayer based upon bushels. Patrons Net Margins attributable to the feed, energy and agronomy allocation units are allocated among the members doing business with each unit based upon their dollars of purchases from Taxpayer. Because the net margins earned on direct business are significantly lower than the net margins earned on other business, Taxpayer separately figures patronage dividends for grain direct and for agronomy direct business. The patronage dividends for grain direct business are allocated based on bushels. The patronage dividends for agronomy direct business are allocated based upon dollars of purchases.

Section 7.5(A) of the Bylaws authorizes Taxpayer to pay patronage dividends in "cash, capital stock or in Capital Credits (or any combination of these).…" Taxpayer expects that its patronage dividends will be paid in a combination of cash and Capital Credits, and that the Capital Credits will be "qualified written notices of allocation" as defined in subchapter T of the Code. Taxpayer also has the authority to pay patronage dividends in nonqualified written notices of allocation. Bylaws, Section 1.13.

In the event of dissolution, Article 7 of Taxpayer's Articles of Incorporation provides that after creditors have been paid amounts remaining are to distributed first to the holders of A Preferred, B Preferred, C Preferred and D Preferred stock in an amount equal to par value, second to the holders of F Preferred stock in an amount equal to pay

value, third to the holders of common stock, E Preferred and Capital Credits in an amount equal to par value or stated dollar value as the case may be. Any residual assets then remaining are then to be shared by the members "on the basis of their respective aggregate Patronage Transactions over the previous ten (10) years as shown by the records of the Association."

This ruling relates to Taxpayer's grain marketing activities. Taxpayer operates grain elevators located strategically across the territory it serves. It purchases grain from its members at the elevators for marketing on a cooperative basis. From the elevators grain can be shipped by truck or rail. The storage capacity of Taxpayer's grain elevators is approximately bushels. Taxpayer also purchases some grain from its members and other for sale directly to several large customers. The grain is delivered by members directly to the customers' facilities.

Taxpayer sells grain to livestock producers for feed, to grain processors to be use 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 members and others, 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 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. Based on the past operations of Taxpayer's predecessors, Taxpayer anticipates that approximately to percent of the grain it markets will be acquired from persons not entitled to share in patronage dividends. For purposes of this ruling, "grain payments" also do not include patronage dividends paid to members with respect to grain marketed for them.

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

Taxpayer pays each member a market price for his or her grain. What that market price is depends upon where, when and how a member chooses to sell his or her grain to Taxpayer. That market price is determined without regard to the actual net proceeds realized by Taxpayer from marketing the grain. Payments are made in cash

(by check) and occur throughout the year as members 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 member's grain along with the grain 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, Taxpayer pays a patronage dividend to its members with respect to the grain they market through Taxpayer.

Grain 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 basis choices, there are additional options available to farmers.

One way for a member to sell grain to Taxpayer for marketing is to sell the grain to Taxpayer and be paid the cash bid price. 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 prices are delivered prices at the particular elevator for grain of normal merchantable quality. Farmers are responsible for the costs of delivering the grain to the elevator. Grain is tested when it is delivered. The grain price is subject to adjustment if the grain is below normal quality standards, provided the grain is still full of acceptable quality.

For the convenience of members, Taxpayer's bid schedule shows both the "cash price" bid and the "basis" bid at each delivery location. This is done because some farmers like to focus on the cash bid price (the futures price plus or minus the basis) while others like to focus just on the basis. The futures prices at the time the schedule

was printed are also listed on the schedule. As described above, the cash price at any location at any time equals the futures price minus the basis at that particular location.

A member 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.

A member has the option of entering into a forward contract to sell his or her grain to Taxpayer. This is the most common way for members to sell their 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 or by contacting Taxpayer.

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 can also enter into forward contract 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. A farmer who believes that basis levels are strong, but that futures prices could improve might use this kind of pricing. 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. This kind of pricing is used if the futures price meets the farmer’s objective, but he or she believes that the basis will improve. A somewhat more complicated form of contract that is offered by some

cooperatives leaves the basis open and places a floor under the futures price. If futures prices go down, the farmer is protected. If futures prices go up beyond a set threshold (which is higher than the minimum price), the farmer can share in the appreciation.

Members 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 delayed 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 full the open price term. Once the price is determined the 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.

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 fixed price forward contracts. Some farmers prefer to do so after they can estimate the costs of production to lock in a reasonable margin. The simplest way to do this is to enter into a fixed price purchase contract.

If a farmer is happy with the futures price, but not the basis, the farmer can enter into a basis purchase contract. If a farmer is happy with the basis, but not the futures price, the farmer can enter into a futures/cash purchase contract. If a farmer wants to lock in a minimum futures price, but benefit in any strengthening of the futures price and leave the basis open, he can enter into a put/cash purchase contract.

If farmers think that the cash price is low at the time of harvest, they can harvest and store their crops either on the farm (if they have on-farm storage) or at one of Taxpayer's elevators while waiting for the price to improve. They can sell that grain to Taxpayer when they think the price is right at the current cash bid price. Alternatively, farmers can deliver the crops to Taxpayer at the time of harvest and enter into a delayed price purchase contract, keeping the pricing open, but not having to bear the costs of storage.

These choices are available to all members 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 each receive the same patronage dividend.

For their full fiscal years ended in , Taxpayer's predecessors made grain payments to members of approximately $ . They paid patronage dividends to members with respect to that year of approximately $ , of which approximately $ was paid with respect to grain business.

Taxpayer's predecessors treated grain payments made in cash to members as "purchases" for tax purposes and reported them on Schedule A, Line 2 of their Forms 1120-C. They did not report grain payments made in cash as "per-unit retain allocations paid in money" and therefore did not report them on Schedule A, Line 4b of their Forms 1120-C. They reported the patronage dividends paid to members in money and qualified written notices of allocation on Schedule H, lines 3a and 3b of their Forms 1120-C.

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

Taxpayer's predecessors did not add back grain payments in their section 199 computations for prior years. They did not pass any portion of their section 199 deductions through to their members in prior years.

Recent developments have caused Taxpayer to reconsider how it should treat grain payments for purposes of its section 199 computation. Taxpayer is seeking confirmation that all grain payments to members should be classified as "per-unit retain allocations in money."

Taxpayer plans to disregard grain payments made to members for purposes of computing its qualified production activities income and its taxable income beginning with its tax return. Taxpayer may retain all, pass through all, or retain part and pass through part of its section 199 deductions in future years.

Based on the foregoing, Taxpayer requests the following rulings:

1. Grain payments to members and other participating patrons 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 participating patrons.

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 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 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.

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 fund credits).

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 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 participating patrons, and members and other participating 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 participating patrons 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 the reasons described above, Taxpayer's crop payments to members and other participating patrons 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.

Accordingly, we rule as requested that:

1. Grain payments to members and other participating patrons 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 participating patrons.

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*

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

cc: