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LEGEND:

Taxpayer =

State A =

Dear

This is in response to a request for rulings dated May 10, 2010, and subsequent correspondence, 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 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. Taxpayer was formed in as a result of the consolidation of two State A cooperatives. Both of Taxpayer's predecessors traced their history back to the s.

Taxpayer markets grain for its farmer members and for other patrons. During its fiscal year ended , Taxpayer's grain sales were approximately $

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

Taxpayer pays patronage dividends to members and to certain nonmember patrons. In order to be a member, a person must be a producer of agricultural products who patronizes Taxpayer and is also a member of the On , Taxpayer had approximately members. Although patronage dividends are paid to some nonmember patrons, most business with nonmembers is on a nonpatronage basis.

Taxpayer is organized and operated on a cooperative basis. Taxpayer is organized under the of State A (the "Act"). The Act provides that associations organized under the Act "shall be deemed 'nonprofit,' inasmuch as they are not organized to make profit for themselves, as such, or for their members, as such, but only for their members as producers." Section of the Act, . The Act directs cooperatives to distribute any net income as patronage dividends:

> "Net income in excess of additions to reserves and surpluses so established, shall be distributed to the members or patrons of the association on the basis of patronage." Section of the Act,

In accordance with the Act, Taxpayer's Articles of Incorporation provide that its purpose is, among other things:

> "(a) To engage in any cooperative activity for the mutual benefit to its common stockholders and patrons in connection with the purchasing or distribution of farm supplies or the production, marketing or selling of agricultural products; …" Articles of Incorporation, Article 2(a).

The Articles of Incorporation provide that Taxpayer's members are the persons who are its common stockholders. Articles of Incorporation, Section 13. In order to be a common stockholder, a person must be a producer of agricultural products who patronizes Taxpayer and is a member of the . Articles of Incorporation, Section 12. The Bylaws of Taxpayer define a "producer of agricultural products" as "any individual, firm, partnership, corporation or association engaged in the production of agricultural products." Bylaws, Article III, Section 2.

The Articles of Incorporation provide that, after paying dividends on preferred stock:

> "… all remaining income, after setting aside such reasonable and adequate reserves as may be determined by the Board of Directors within the limits prescribed by the terms of The ,
> as amended, shall be distributed on the basis of patronage (1) to common stockholders, (2) to other patrons who are either members of the [State A]
> and a good standing
> or which are partnerships, unincorporated associations or corporations engaged in the production of agricultural products if all the individual members of such partnerships or unincorporated associations or stockholders of the corporation are members in good standing, spouses of members or dependents of members of [State A]
> and a ." Article 10(f).

Thus, Taxpayer pays patronage dividends to common stockholders (i.e., its members) and to certain "other patrons" (i.e., certain nonmember patrons). Relatively few of Taxpayer's nonmembers qualify as "other patrons." Thus, most of Taxpayer's nonmember business is conducted on a nonpatronage basis.

During , approximately percent of Taxpayer's grain business and percent of Taxpayer's supplies business was with members and nonmember patrons entitled to share in patronage dividends. The remaining percent of Taxpayer's grain business and percent of Taxpayer's supplies business was done with nonmembers not entitled to share in patronage dividends.

The Bylaws repeat what is contained in the Articles of Incorporation with respect to the distribution of net earnings as patronage dividends. They go on to provide that:

> "Patronage refunds may be paid at different rates on different classes of commodities, supplies, merchandise or services according to the earnings on the respective classes." Bylaws, Article VII, Section 3.

Taxpayer allocates patronage dividends upon the basis of departments (Crops, Feed and Structures, Energy and Grain) and product categories within each of the departments. For instance, in Taxpayer had net earnings in and thus paid patronage dividends with respect to product categories in the Crops Department. In the Feed Department, Taxpayer had net earnings in and thus paid patronage dividends. In the Energy Department, Taxpayer had net earnings in and thus paid patronage dividends.

In the Grain Department, Taxpayer computes patronage dividends based upon two allocation units – one for grain delivered to the elevators that Taxpayer operates "elevator bushels"), and the second for grain delivered, at Taxpayer's direction, to one of its customer's elevators ("direct bushels"). Two allocation units are used because the margins on elevator bushels consistently differ significantly from the margins on direct

bushels. In , direct bushels did not generate a net profit, so patronage dividends were paid only with respect to elevator bushels.

The Bylaws require that at least percent of any patronage dividend be paid in cash (if it is intended that the noncash portion of the patronage dividend be "qualified," as that term is defined in subchapter T of the Code). The remainder can be distributed "in whole or in part, in cash, in preferred capital stock or credit upon capital stock, in patronage refund notes or in credits upon patronage refund notes or in certificates of indebtedness or in any other written notices of allocation." Bylaws, Article VII, Section 4. Patronage dividends are normally paid in a combination of cash and Class F Preferred stock, which has a par value of $25 per share and is not paid any dividend. Capital stock credits are issued in lieu of fractional shares of Class F Preferred stock. In the past, the shares of Class F Preferred stock distributed by Taxpayer as part of its patronage dividends have been "qualified written notices of allocation" as defined in subchapter T.

In the event of dissolution, Article 10(e) of Taxpayer's Articles of Incorporation provides that, after creditors have been paid, amounts remaining are to be distributed first to the holders of the Class C Preferred stock in an amount equal to par value, and second to the holders of Class F Preferred stock in an amount equal to par value. Any residual assets are to be shared among past and present members of Taxpayer (and its predecessors) on a patronage basis. Holders of the common stock and of the Class B Preferred stock are not entitled to receive anything with respect to their shares on dissolution.

Taxpayer's grain business consists of buying grain from members and others and then selling the grain to terminal grain elevators, grain processors, grain exporters and others. Taxpayer sells grain to livestock producers and dairy farmers 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.

Some of the grain that Taxpayer buys is delivered by farmers to one of the grain elevators Taxpayer operates. Taxpayer receives this grain and stores it until it is shipped to customers. Taxpayer's elevators have a storage capacity of approximately million bushels. The grain is shipped to customers by truck. As indicated above, grain that is handled in this manner is referred to by Taxpayer as "elevator bushels."

Some of the grain that Taxpayer buys is sold by Taxpayer directly to customers, such as terminal elevators, feed mills, or grain processors. Taxpayer is the purchaser of this grain, and is responsible for paying farmers for the grain. Taxpayer sells the grain to its customers and is paid by them. However, Taxpayer does not handle this grain since its members deliver it, at Taxpayer's direction, to Taxpayer's customer's facilities. This grain is referred to by Taxpayer as "direct bushels."

The issues in this ruling request relate 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 to nonmember patrons entitled to share in patronage dividends when it acquires their grain for marketing on a patronage basis. For purposes of this ruling, the term “grain payments” does not include any amounts paid to persons not entitled to share in patronage dividends. In addition, the term “grain payments” does not include patronage dividends paid to members and nonmember patrons entitled to share in patronage dividends 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 grain to 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 market price paid for grain 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 patronage dividends to members and certain nonmember patrons with respect to the grain they market through Taxpayer.

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 contract.

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
) 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 above or below normal quality standards, provided the grain is still of acceptable quality.

Grain prices constantly fluctuate. While basis does not fluctuate as dramatically as the futures prices, it also is variable. As a result of changes in the markets, the bid price schedule at country elevators changes from hour to hour and day to day.

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.

When a farmer delivers grain to Taxpayer for storage, the farmer is issued a warehouse receipt. A farmer retains ownership of the grain in the elevator and pays storage fees to Taxpayer. Later, when the 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. 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 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 also can enter into forward contracts where the pricing is left open for future determination prior to delivery.

- 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 would be used if the futures price met the farmer's objective, but he or she felt the basis would improve.

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. Taxpayer refers to them as "price later contracts."

Under a price later 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 member is paid.

The variety of options available to farmers for selling grain to Taxpayer and other grain companies provide farmers with a great deal of flexibility. By entering into a fixed price forward contract, a farmer can lock in a price for his or her crops at any time if he or she thinks the price for future delivery is right. 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 hedge to arrive contract. Fixed price forward contracts, basis contracts and hedge to arrive contracts can be entered into before the crops are planted, while crops are growing, at the time of harvest, or while crops are in storage after harvest.

If a farmer thinks that the cash price is low at the time of harvest, the farmer can harvest and store his or her crops either on the farm (if the farmer has on-farm storage) or at one of Taxpayer's elevators while waiting for the price to improve. A farmer can

then sell that grain to Taxpayer when he or she thinks the price is right at the current cash bid price.

Alternatively, a farmer can deliver crops to Taxpayer at the time of harvest and enter into a price later 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.

For the fiscal year ended , Taxpayer made grain payments to members and nonmember patrons entitled to share in patronage dividends of approximately $ million. Taxpayer paid patronage dividends to members and certain nonmember patrons with respect to their grain of $. Patronage dividends were paid in 50 percent in cash and 50 percent in qualified written notices of allocation (Class F Preferred stock and stock credits).

In the past, Taxpayer has treated grain payments made in cash to members 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. Taxpayer has reported the patronage dividends paid to members in money and qualified written notices of allocation on Schedule H, lines 3a and 3b of its Form 1120-C.

Because of this reporting, grain payments paid in cash have entered into the determination for tax purposes 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 has not added back grain payments in its section 199 domestic production activities deduction in the past and has not passed any section 199 deductions through to members and nonmember patrons eligible to share in patronage dividends.

Recent developments have caused Taxpayer to focus on the section 199 deduction. Taxpayer is seeking confirmation that all grain payments to members and to nonmember patrons eligible to share in patronage dividends should be classified as "per-unit retain allocations paid in money."

Taxpayer plans to disregard grain payments made to members and to nonmember patrons eligible to share in patronage dividends for purposes of computing its qualified production activities income and its taxable income. Taxpayer does not currently plan to make any change in the manner it accounts for inventories for tax purposes. Thus, the timing of the deduction of its grain payments will not be changed. Taxpayer will make certain that it does not exclude or deduct grain payments twice on

its tax return and that it does not add back grain payments twice in its section 199 computation.

In the future, Taxpayer may retain all of its section 199 deduction, pass through all of the deduction to members and other patrons eligible to share in patronage refunds, or pass through part and retain part of the deduction.

Based on the foregoing, Taxpayer requests the following rulings:

1. Grain payments to members and other patrons entitled 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 entitled 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 otherwise meet the requirements of subchapter T of the Code.

Section 1388(f) of the Code defines the term “per-unit retain allocation” to mean “any allocation, by an organization to which part I of [subchapter T] applies, to a patron with respect to products marketed for him, the amount of which is fixed without reference to net earnings of the organization pursuant to an agreement between the organization and the patron.”

Per-unit retain allocations may be made in money, property or certificates. Per-unit retain allocations paid in money and in property are excludable or deductible under section 1382(b)(3) of the Code. Per-unit retain allocations paid in certificates are deductible under section 1382(b)(3) if the certificates are qualified. If the certificates are nonqualified, the cooperative is permitted a deduction under section 1382(b)(4) (or a tax benefit figured under section 1383) when the certificates are later redeemed.

Section 1388(a)(1) of the Code provides that the term “patronage dividend” means an amount paid to a patron by a cooperative on the basis of the quantity or value of business done with or for such patron. Section 1388(a)(2) provides that a “patronage dividend” is an amount paid “under an obligation” that must have existed before the cooperative received the amount so paid. Section 1388(a)(3) provides that “patronage dividend” means an amount paid to a patron that is determined by reference to the net earnings of the cooperative from business done with or for its patrons. That section further provides that a “patronage dividend” does not include any amount paid to a patron to the extent that such amount is out of earnings other than from business done

with or for patrons. Section 1.1382-3(c)(2) of the 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 provides 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, which it markets, and various farm supplies, which it sells to its members).

As a specified agricultural or horticultural cooperative, Taxpayer is entitled to the benefit of section 199(d)(3)(C) of the Code and section 1.199-6(c) of the regulations, which permit such cooperatives to disregard deductions under section 1382(b) and (c) for purposes of computing QPAI and taxable income for 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 the 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 have a number of options for determining how and when sales are made. As stated above, 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 marketing operations in proportion to the quantity of grains 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 this ruling 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.

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 patron for marketing by Taxpayer. As described above, Taxpayer markets the grain it acquires from patrons, and 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 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."

Taxpayer has treated its grain payments as "purchases," not as "per-unit retain allocations paid in money." However, how the payments have been reported by Taxpayer in prior years does not determine how the payments are treated prospectively in this ruling.

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 grain payments to 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.

We note that payments to nonmembers who are not eligible to share in patronage dividends (i.e., those with whom 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. Grain payments to members and other patrons entitled 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 entitled 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 grains 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)