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Legend

Taxpayer =

State A =

State B =

Dear :

This is in response to a request for rulings dated July 16, 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), the calculation of the section 199 deduction for certain cooperatives contained in section 199(d)(3), and the affect of a cooperative passing through the cooperative's section 199 deduction to patrons with respect to a year in which it incurs a net operating loss on the loss available to be carried back or forward under section 172.

Taxpayer is a farmers' cooperative organized under State A law. Taxpayer is a local grain marketing and farm supply cooperative. It is headquartered in State A. It serves farmers located in a county area in State A and State B. Taxpayer is the result of the consolidation in of State A cooperatives –

. Since that consolidation, Taxpayer has expanded into State B, acquiring grain elevators and farm supply operations in that state.

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

. Principal commodities marketed in its fiscal year were corn and soybeans. Taxpayer also marketed some wheat, milo, and a small amount of oats. In addition to grain marketing, Taxpayer provides farm supplies to its farmer members and other patrons – including principally fertilizer, agricultural chemicals, petroleum products, feed, seed and merchandise. During its fiscal year, Taxpayer's farm supply sales totaled approximately $.

Taxpayer's "members" are farmers who do business with it. Each member owns one share of Taxpayer's capital stock (par value $10) and is entitled to share in the net earnings of Taxpayer in the form of patronage dividends. Taxpayer currently has approximately members.

Other persons who wish to do business with Taxpayer on a patronage basis are eligible to become "participating patrons" of Taxpayer. Each participating patron is required to own a Certificate of Participation (stated dollar amount is $10) and is entitled to share in net earnings of Taxpayer in the form of patronage dividends. Participating patrons do not have voting rights. Taxpayer currently has approximately participating patrons.

Taxpayer is organized as a cooperative corporation pursuant to Sections to of the State A Statutes. These sections set for the basic requirements for cooperative operation. To the extent not inconsistent with what is provided in these sections, cooperative corporations are governed generally by the Business Corporation Act of State A (Sections).

Section provides that cooperative corporations are formed "by the adoption of articles of incorporation in the same manner and with like powers and duties required of other corporations except as provided in sections to ."

Section requires that, among other things, a cooperative corporation must include in its articles of incorporation:

> "… (2) That dividends on the capital stock shall be fixed but shall not exceed eight percent per annum of the amount actually paid thereon; (3) That the net earnings or savings of the company remaining after making the distribution provided in subdivision (2) of this section, if any, shall be distributed on the basis of or in proportion to the amount or value of property bought from or sold to members, or members and other patrons, or of labor performed or other services rendered to the corporation. … (4) That the articles of incorporation or the By-laws of the company shall give a detailed statement of the method followed in distributing earnings or savings…"

Section enumerates various powers that cooperative corporations may exercise, including the power "(6) to set aside each year to a surplus fund a portion of the savings of the company over and above all expenses and dividends or interest upon capital stock which surplus may be used for conducting the business of the corporation."

The preamble to Taxpayer's Articles of Incorporation provides that the Articles were adopted "to further the purpose of conducting business as a cooperative corporation" pursuant to State A law. This is repeated in Article I of Taxpayer's Bylaws:

> "This Cooperative is an agricultural cooperative corporation formed to promote and provide a medium for unity of effort by farmers and producers of agricultural products, including livestock, in the handling and marketing of grain and other agricultural products and to operate as provided in the Agricultural Marketing Act, approved June 15, 1929, as amended and to do anything that is conducive to carrying out the policy of Congress as stated in that Act, and also the Capper-Volstead Act, as approved February 18, 1922, as amended."

Article IX of Taxpayer's Articles of Incorporation provides for the sharing of earnings on a cooperative basis:

> "**ARTICLE IX**
> **<u>Distribution of Earnings</u>**
>
> **Section 1**. After deducting all expenses which are lawfully deductible or excludable in determining the net margins of the Cooperative, the Board of Directors shall establish and deduct reasonable amounts for reserves, at such rates as shall be provided in the Bylaws of the Cooperative.
>
> **Section 2**. The remaining net margins, after providing for the deductions under Section 1 of this Article, shall belong to and be held for the stockholders and patrons and shall be apportioned among them on a patronage basis at the close of each fiscal year, as provided in the Bylaws of the Cooperative.
>
> **Section 3**. The Bylaws of the Cooperative shall establish the methods to be followed in distributing savings."

Taxpayer's Articles of Incorporation provide that it is organized on a stock basis. Stock may be owned only by: "… persons, including both landlords and tenants in share tenancies, who are bona fide producers of agricultural products in the trade territory served by the Cooperative, who patronize the Cooperative." Article IV, Section 5. These persons are the members of Taxpayer and are referred to in this ruling as "members." Each stockholder is permitted to own only one share of stock and is entitled to only "one vote in the affairs of the Cooperative." Article IV, Sections 3 and 4. There are no dividends paid on stock. Article IV, Section 2.

Persons not eligible to own capital stock, but wanting to do business with Taxpayer on a patronage basis, are permitted to become "participating patrons" as defined in Taxpayer's Bylaws, Article II, Section 7, and to hold a "Certificate of Participation." Such persons have "all the rights and privileges of a stockholder" (i.e., they are entitled to share in patronage dividends), except they may not vote (Article IV, Section 6), and are referred to in this ruling as "participating patrons."

Article VIII of Taxpayer's Bylaws provides a detailed description of how Taxpayer computes and pays patronage refunds. Section 1 begins by defining the term "net margins," which is the starting point for Taxpayer's patronage dividend computation:

> "Section 1. Net Margins. The gross receipts of the Cooperative shall include all proceeds from commodities marketed for patrons, plus all sums received for supplies and equipment and services procured for patrons, plus all income from all other sources. From the gross receipts shall be deducted all costs and expenses and other charges which are lawfully excludable or deductible from this Cooperative's gross income for the purpose of determining the amount of margins for the period."

In determining "net margins" for this purpose, Taxpayer deducts what it pays (other than patronage dividends) to members and other patrons for the grain that it markets for them on a patronage basis.

Section 2 provides that no dividends shall be paid on capital stock, and, as a result, net margins are not reduced by dividends.

Section 3 provides that the net margins shall be reduced by reasonable reserves for necessary business purposes and by "the margins found to be attributable to business done with the U.S. Government and from non-patronage sources if not distributed to the patrons." If the margins attributable to business with the U.S. Government and nonpatronage sources are less than 10 percent of net margins, then Taxpayer is also required to retain the difference. Amounts held back under Section 3 are added to retained earnings.

Section 4 then provides: "Apportionment to Patrons. The balance of said margins which remain shall be deemed to be patrons' net margins. All of the patrons' net margins shall, as received by the Cooperative, belong to and be held for the patrons and shall be apportioned among them on a patronage basis at the close of each fiscal year."

Section 5 provides that allocation units may be used in determining how to apportion net savings on a patronage basis. Taxpayer uses a single allocation unit for its grain marketing business, allocating patronage dividends on the basis of bushels of grain marketed through Taxpayer. Taxpayer accounts for its grain storage and drying business in a separate allocation unit, allocating patronage dividends on the basis of dollars of storage and drying fees paid to Taxpayer. Taxpayer accounts for its feed and feed services business in a separate allocation, allocating patronage dividends based on dollars of feed purchases and feed service charges. Taxpayer currently uses three allocation units for its supplies business – (i) merchandise, (ii) agronomy products and services, and (iii) petroleum products. The merchandise and agronomy allocation units allocate patronage dividends based upon dollars of purchases and the petroleum allocation unit allocates patronage dividends based on gallons.

Section 6 requires the allocated amounts be paid to patrons, but permits the Board to pay a portion of the patronage dividend in written notices of allocation (referred to by Taxpayer as “Revolving Fund Credits” or “Members’ Equity Credits”).

In the event of dissolution, Article IX of Taxpayer’s By-laws provides that assets will first be used to pay all debts and liabilities. Remaining assets will then be distributed to the holders of Members’ Equity Credits in an amount equal to the stated dollar amount of the Credits. The holders of capital stock and Certificates of Participation will then be entitled to receive what they paid for them. Any residual assets then remaining will be shared on a patronage basis “among the equity holders on the basis of their respective deferred patronage accounts as shown on the records of the cooperative insofar as possible.”

In the event that Taxpayer incurs a loss, Section 7 of Article VIII authorizes Taxpayer (among other things) to “charge such loss against the Revolving Fund Credits and other equity held by those stockholders and participating patrons whose patronage gave rise to such loss.”

This ruling relates to Taxpayer’s grain marketing activities. Taxpayer operates grain elevators located in State A and State B with a licensed storage capacity of just over bushels of grain. Taxpayer ships grain by both truck and rail.

Taxpayer sells grain to livestock producers for feed, to grain processors to be used to produce ethanol, high-fructose corn sweetener and other products, to soybean processors to be crushed and sold as soybean meal, oil and other further refined products, and to others for resale, both domestically and in the export market.

Taxpayer’s grain business consists of buying grain from members and participating patrons, handling and storing the grain at its elevators, and then selling the grain to terminal grain elevators, grain processors, feed lots, grain exporters and others. An issue in the request for rulings relates to the characterization for purposes of subchapter T of the Code and section 199 of payments (referred to in this ruling as "grain payments") that Taxpayer makes to members and participating patrons 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. During its fiscal year ended , only approximately percent of Taxpayer's grain business was done with persons not entitled to share in patronage dividends. For purposes of this ruling, "grain payments" also do not include patronage dividends paid to members and participating patrons 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 and participating patrons to a pool at the time of harvest. Rather, that risk remains with members and participating patrons until they sell their grain to Taxpayer for marketing.

Taxpayer pays each member and participating patron a market price for his or her grain. What that market price is depends upon where, when and how a member or participating patron 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 and participating patrons sell grain to Taxpayer for marketing and are paid pursuant to the terms of their grain contracts.

After purchasing grain from members and participating patrons, Taxpayer then markets each member's and participating patron's grain in the manner that it judges will produce the best return. After year end, when net earnings for the year have been determined, Taxpayer pays a patronage dividend to its members and participating patrons 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 (participating patrons have the same alternatives as farmers when they sell their grain to Taxpayer). The choices are similar to those offered farmers by commercial grain companies, though commercial grain companies do not market grain on a patronage basis and do not pay patronage dividends.

The basic choices available to a farmer selling grain to Taxpayer for marketing on a cooperative basis are: (i) to sell the grain for Taxpayer's current cash bid price, (ii) to sell the grain to Taxpayer using a forward contract, and (iii) to sell the grain to

Taxpayer using a deferred price or a deferred payment contract. Under each of these basic choices, there are additional options available to farmers.

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

For the convenience of its members and participating patrons, Taxpayer publishes two bid schedules. One shows the "flat price" bid at each delivery location, and the other shows the "basis" at each location. Two schedules are published because some farmers like to focus on the flat bid price (the futures price plus or minus the basis) while others like to focus on the basis. The futures prices are shown at the end of the basis schedule. The locations shown on the first part of each schedule are those owned and operated by Taxpayer, and the prices at those locations are delivered prices (i.e., the farmers are responsible for the costs of delivering the grain to those facilities). Those shown on the second part of the schedule are plants or terminal locations owned by customers of Taxpayer. These prices are also delivered prices. Taxpayer's members and participating patrons delivering grain "direct" to those plants or terminals sell the grain to Taxpayer, who in turn resells it to the customers at those locations.

The bid prices are for grain of normal merchantable quality. Grain is tested when it is delivered. There are standard price adjustments if the grain is below standard grade, but still of acceptable quality. When a farmer delivers grain to Taxpayer for a spot sale at the cash bid price, a grain settlement document is produced, identifying the kind, amount and quality of the grain delivered, the price per bushel, any applicable discounts or other charges, and the net amount owed to the member or participating patron.

A farmer can deliver and sell grain to Taxpayer at the cash bid price at the time of harvest, delivering the grain directly from the field. However, it usually is not advantageous for a farmer 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 farmer has the option of entering into a forward contract to sell his or her grain to Taxpayer. Forward contracts call for delivery of a specified quantity and quality of grain, at a specified location, during a specified time period. Forward contracts can be entered into before the grain is planted, while it is growing or after harvest while the grain is being stored on the farm or in an elevator.

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

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

Farmers also can enter into a forward contract where the pricing is left open for future determination. For instance, the contract may fix the basis and leave the futures price open, to be determined based upon the futures price at the time chosen by the farmer before a specified date in the future. Alternatively, the contract 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.

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

The variety of options available to farmers for selling their grain to Taxpayer and other grain companies provide farmers with a great deal of flexibility. Farmers can lock in prices for their crops (even before they are planted or while they are growing) at any time if they think that the price is right by using flat price forward contracts. Some farmers prefer to do so after they can estimate the costs of production to lock in a reasonable margin. If a farmer is happy with the futures price, but not the basis, the farmer can enter into a forward contract that leaves the basis open. If a farmer is happy with the basis, but not the futures price, the farmer can enter into a forward contract that leaves the futures price open. If farmers think that the cash price is low at the time of harvest, they can harvest and store their crops while waiting for the price to improve. Alternatively, farmers can deliver the crops and enter into a deferred price contract.

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

For the fiscal year ended , Taxpayer made grain payments to members and participating patrons of approximately $. Since Taxpayer incurred a loss during its fiscal year, it did not pay patronage dividends to members and participating patrons with respect to their grain.

In the past, Taxpayer has treated grain payments made in cash to members and participating patrons 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 and participating patrons as a patronage dividend paid 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 did not add back grain payments in its section 199 computations for prior years. Taxpayer did not pass any portion of its section 199 deduction through to its members or participating patrons in prior years.

For its fiscal year ended , Taxpayer reconsidered how it should treat its grain payments for purposes of its section 199 computation. In its calculation of its section 199 deduction for that year, Taxpayer added back grain payments in determining its qualified production activities income (QPAI) and taxable income limitation. Taxpayer reported a section 199 deduction of approximately $, all of which it passed through to members and participating patrons pursuant to section 199(d)(3)(A) of the Code. Taxpayer reported the section 199 deduction on line 22 of its return, but, as required by section 199(d)(3)(B), reduced its deduction for grain payments (reflected in its cost of goods sold) by the amount of the section 199 deduction passed through. Thus, the passed-through section 199 deduction had no net impact on Taxpayer's taxable income for the year.

Taxpayer incurred a net operating loss (NOL) deduction (without regard to its section 199 deduction) for its fiscal year ended . Taxpayer made an election pursuant to section 172(b)(3) of the Code to forego the carryback period for that loss. Thus, all of that loss is available for carryover to Taxpayer's fiscal year ended and later years.

For its fiscal year ended , Taxpayer is seeking confirmation that all grain payments to members and participating patrons that are paid in cash should be classified as "per-unit retain allocations paid in money." Taxpayer is also seeking confirmation that section 172(d)(7) does not preclude it from claiming a NOL deduction in its fiscal year ended for the NOL incurred in the fiscal year ended . Taxpayer's tax return for its fiscal year ended has not yet been filed.

For its fiscal year ended , and future years, Taxpayer may retain all, pass through all, or retain part and pass through part of its section 199 deduction.

Taxpayer has not changed the manner it accounts for its grain inventories as a result of adding back grain payments in its section 199 computation. Thus, the timing of the deduction of its grain payments has not 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.

Based on the foregoing, Taxpayer requests the following rulings:

1. Grain payments to members and 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 participating patrons.

3. Section 199 deductions which Taxpayer passes through to members and participating patrons with respect to a year in which it incurs a net operating loss will not affect the amount of the loss available to be carried back or forward under section 172 of the Code.

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 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).

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 members and participating patrons and markets that grain. The amount that each member and participating patron receives when he or she sells grain to Taxpayer for marketing depends upon where, how, and when the member or participating patron chooses to sell that grain to Taxpayer. Members and participating 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.

Members and participating 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 members and participating 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).

An issue presented in Taxpayer's request for rulings is whether the grain payments made by Taxpayer during its fiscal year ended , to members and participating 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 issue determines who gets to include the grain payments in the section 199 computation. If the grain payments to members and participating 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 members' and participating patrons' section 199 computations. If the grain payments to members and participating 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 members' and participating patrons' section 199 computations. These results are the same whether Taxpayer decides to keep or to pass-through all or a portion of its section 199 deduction.

Grain marketing cooperatives like Taxpayer have never thought of their grain payments as per-unit retain allocations paid in money. However, Taxpayer's grain payments appear to meet the definition of "per-unit retain allocations paid in money" which are excludible or deductible under section 1382(b)(3) of the Code. The grain payments are made in cash so the "paid in money" requirement is met.

Taxpayer's grain payments also meet all the requirements of the definition of "per-unit retain allocation" contained in section 1388(f) of the Code, which defines the term "per-unit retain allocation" to mean "any allocation, by an organization to which part I of this subchapter applies, to a patron with respect to products marketed for him, the amount of which is fixed without reference to the net earnings of the organization pursuant to an agreement between the organization and the patron."

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

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

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 members and 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.

Another issue presented in Taxpayer's request for rulings is whether section 199 deductions which Taxpayer passes through to members and participating patrons with respect to a year in which it incurs a net operating loss will or will not affect the amount of the loss available to be carried back or forward under section 172 of the Code.

Taxpayer is a "specified agricultural or horticultural cooperative" described in section 199(d)(3)(F) of the Code. Taxpayer's activities generate QPAI within the meaning of section 199(a). Taxpayer represents that it will provide its members and participating patrons with written notice of the amount deductible under section 199 within the time and in the manner required by section 199(d)(3)(A)(ii). Therefore, under section 199(d)(3)(A), Taxpayer's section 199 deductions will be passed-through to its members and participating patrons, and the members and participating patrons will be allowed a portion of the Taxpayer's deduction allowed under section 199(a).

Section 199(d)(3)(B) of the Code provides that the taxable income of a specified agricultural or horticultural cooperative shall not be reduced under section 1382 by reason of that portion of any qualified payment as does not exceed the deduction allowable under section 199(d)(3)(A) with respect to such payment.

In general, section 1382(c) of the Code allows a cooperative a deduction for patronage dividends and certain retain allowances, in addition to other deductions allowable under Chapter 1 of the Code.

Section 172(a) of the Code allows a deduction for (1) the NOL carryovers to the taxable year and (2) the NOL carrybacks to the year. Section 172(c) provides that the term "net operating loss" means the excess of the deductions allowed by Chapter 1 of the Code over the gross income, computed with the modifications specified in section 172(d). Section 172(d)(7) states that the deduction under section 199 is not allowed.

If the section 199 deduction is passed through to the members and participating patrons, then the members and participating patrons are allowed an allocable portion of such deduction. Section 172(d)(7) of the Code will apply to each member and participating patron, and the section 199 deduction is not allowed in computing the member or participating patron's NOL for the taxable year. However, if the cooperative passes through the section 199 deduction to members and participating patrons, then the cooperative still must report the section 199 deduction on its return. To prevent the double deduction of the section 199 amount (i.e., by the cooperative as well as the members and participating patrons), section 199(d)(3)(B) requires the cooperative to reduce its deduction under section 1382 by the amount of the section 199 deduction passed-through.

Taxpayer argues that its NOL for the year should be computed without regard to the reduction required by section 199(d)(3)(B) of the Code. Because of the offset required by section 199(d)(3)(B), Taxpayer argues that it obtains no benefit (i.e., taxable income is not reduced) by the amount of the section 199 deduction. Unless section 199(d)(3)(B) is ignored for purposes of section 172, the taxpayer's NOL for the year will be less than its true economic loss for the year.

The legislative history under section 172(d)(7) of the Code is limited but supports ignoring section 199(d)(3)(B) for purposes of section 172. The Joint Committee on Taxation report states:

> "[Section 172(d)(7)] clarifies that the manufacturing deduction is not taken into account in computing any net operating loss or the amount of any net operating loss carryback or carryover. Thus, the deduction under section 199 cannot create, or increase, the amount of a net operating loss deduction."

Joint Committee on Taxation, Technical Explanation of the Revenue Provisions of H.R. 4440, the "Gulf Opportunity Zone Act of 2005," as Passed by the House of Representatives and the Senate. (JCX-88-05), December 16, 2005.

The purpose of section 172 of the Code is to ameliorate the potentially dramatic effects that the annual accounting system may have on taxpayers with fluctuating, as opposed to stable, income and loss. See U.S. v. Foster Lumber Co, Inc., 429 U.S. 32 (1976). The section 172 deduction is limited to losses incurred in the conduct of a trade or business. The legislative history above indicates that Congress in enacting section 172(d)(7) was concerned with prohibiting a noneconomic loss such as the section 199 deduction from reducing, through the operation of the NOL provisions, taxable income in a taxable year subsequent or prior to the year the section 199 deduction is allowed. There is nothing to suggest that Congress intended to penalize cooperatives and their patrons by reducing the amount of a cooperative's economic losses that may be carried forward or back as provided in section 172 when the cooperative passes through its section 199 deduction to patrons.

In Taxpayer's case, Taxpayer's members and participating patrons in computing their NOL for the taxable year will not be allowed the section 199 deduction under section 172(d)(7) of the Code. This result is consistent with the policy underlying that section. Section 172(d)(7) will also apply to Taxpayer and Taxpayer will disregard the section 199 amount passed through to members and participating patrons in computing Taxpayer's NOL. Unless section 199(d)(3)(B) is similarly disregarded in computing Taxpayer's NOL, Taxpayer's economic loss for the year will not be fully available to offset income in future or past taxable years. This result would be inconsistent with section 172.

Accordingly, we rule as requested that:

1. Grain payments to members and 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 participating patrons.

3. Section 199 deductions which Taxpayer passes through to members and participating patrons with respect to a year in which it incurs a net operating loss will not affect the amount of the loss available to be carried back or forward under section 172 of the Code.

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: