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LEGEND:

Taxpayer =

State A =

b =

Dear

This is in response to a request for rulings dated December 14, 2010, submitted by your authorized representative. The rulings concern the interplay of the rules in subchapter T of the Internal Revenue Code (concerning the taxation of cooperatives and their patrons) and the calculation of the section 199 deduction for certain cooperatives contained in section 199(d)(3).

Taxpayer is a farmers' marketing cooperative headquartered in State A. Taxpayer is engaged in marketing b, including principally, . Taxpayer's sales for its fiscal year ended were approximately $ million.

Most of the b that Taxpayer markets is raised by its members. Taxpayer markets member b on a patronage basis. Taxpayer also markets b raised by nonmembers and purchased from nonmember growers and others, but it does so on a nonpatronage basis. Taxpayer currently has members, each of whom is a significant grower of b

and other crops. Taxpayer's customers are and b brokers in the United States and Canada.

Taxpayer's principal place of business is its facility located in , State A. Taxpayer also leases a in . Because of the location of its members, Taxpayer is able to provide customers with b on a year-round basis.

Taxpayer is a cooperative corporation organized under the State A Cooperative Marketing Act, . Taxpayer was formed in .

The Act provides that corporations may be organized for, among others, the following purposes:

> "… for the purpose of engaging in any cooperative activity in connection with the producing, marketing, or selling of agricultural products; or with the growing, harvesting, preserving, drying, processing, canning, packing, grading, storing, warehousing, handling, shipping, or utilizing such products; or the manufacturing or marketing of byproducts thereof; … on a cooperative basis for those engaged in agriculture as bona fide producers of agricultural products or in any one or more of the activities specified herein." Section .

Entities organized under the Act as cooperatives are "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 .

Under the Act, cooperative marketing associations may be organized either with or without stock. For those organized with stock, the Act provides:

> . – (3) … The association shall limit its dividends on stock both common and preferred, to any amount not greater than 8 percent per annum on the par value thereof, or if such capital stock is without par value, then upon the actual cash value of the consideration received by the association therefor. The association by the vote of its directors, may establish and accumulate reserves out of earnings, including a permanent surplus fund as an addition to capital. Net income in excess of additions to reserves and surpluses so established shall be distributed to the members of the association on the basis of patronage. Any distribution of reserves and surpluses at any time shall be made to members at the time such distribution is ordered on the basis of patronage." Section .

The Act specifically authorizes associations and their members to enter into marketing contracts with members:

> . – The association and its members may make and execute marketing contracts requiring the members to sell, for any period of time, all or any specified part of their agricultural products or specified commodities exclusively to or through the association or any agencies designated by the association. The contracts may provide that the association may sell or resell the products of its members with or without taking title thereto; and pay to its members the resale price, after deducting all necessary selling, overhead and other costs and expenses, including interest or dividends on stock, not exceeding 8 percent per annum, and reserves for retiring the stock, if any; and other proper reserves; and any other proper deductions." Section .

Taxpayer's Articles of Incorporation provide that its purposes are:

> "To engage in any activity in connection with: the producing, marketing, selling, harvesting, preserving, drying, processing, canning, packing, storing, handling, or utilization of any agricultural products produced by its members and other farmers; the manufacturing or marketing of the by-products thereof; the performing or furnishing of farm business services for producers of agricultural products; the manufacturing, purchasing, hiring, or otherwise providing for use by its members and other farmers of supplies, machinery, or equipment; or in the financing of any such activities; or in any one or more of the activities specified; and to exercise all such powers in any capacity and on any cooperative basis that may be agreed upon." Article II.

Taxpayer is organized with capital stock. Article VII. Three classes of capital stock are authorized – Class A common stock (with a par value of $100.00 per share), Class B common stock (with a par value of $100.00 per share) and Preferred Stock (with a par value of $100.00 per share). Article VII, Section 1. Currently, all outstanding shares of Class A common stock and Class B common stock are owned by members of Taxpayer. The Preferred Stock is owned by former members of Taxpayer.

The Common Stock is membership stock. Article VII, Section 2. Only "producers of agricultural products and cooperative associations of such producers approved by the board of directors, who shall patronize the association in accordance with the uniform terms and conditions prescribed thereby…" are eligible to be members and owners of Class A common stock. Article VII, Section 2. As noted above, Taxpayer currently has members, each of whom owns one share of Class A common stock. Each person who is admitted to membership is required to pay $100.00 to purchase one share of Class A common stock. Each eligible holder of Class A

common stock is entitled to one vote (and only one vote) in any meeting of stockholders regardless of the number of shares owned. Article VII, Section 2.

Taxpayer's Class B common stock is subject to the same ownership restrictions as Class A common stock. Article VII, Section 3. It is nonvoting. Article VII, Section 3. Historically, this stock has been used to pay the noncash portion of Taxpayer's unit retains and patronage dividends. The members of Taxpayer own all of the shares of Class B common stock.

When a member leaves Taxpayer, its shares of Class A common stock and Class B common stock are exchanged on a share for share basis for shares of Preferred Stock. Preferred Stock is nonvoting. It is entitled to annual noncumulative dividends not in excess of 8 percent of par value per annum as declared by the Board of Directors of Taxpayer. The only holders of Preferred Stock are nonmembers.

The Articles of Incorporation authorize Taxpayer to pay dividends on common stock, but not in excess of the dividend declared or paid the preferred stockholders (i.e., not in excess of 8 percent of par value per annum). Article VII, Section 4. No dividends have ever been paid with respect to common stock.

The Act authorizes cooperatives to enter into marketing agreements with members:

"The association and its members may make and execute marketing contracts requiring the members to sell, for any period of time, all or any specified part of their agricultural products or specified commodities exclusively to or through the association or any agencies designated by the association. …" Section .

Taxpayer's marketing agreements are in effect for a fiscal year, which for purposes of the agreement runs from through . Taxpayer's marketing agreements continue after the original fiscal year on a year-to-year basis unless either party gives notice of termination at least 30 days prior to the end of the year. Section 7.

Taxpayer has similar agreements with members covering a variety of different kinds of crops, including

The Act goes on to provide that:

> "The [marketing] contracts may provide that the association may sell or resell the products of its members with or without taking title thereto; and pay to its members the resale price, after deducting all necessary selling, overhead and other costs and expenses, including interest or dividends on stock, not exceeding 8 percent per annum, and reserves for retiring the

stock, if any; and other proper reserves; and any other proper deductions." Section .

Taxpayer's standard marketing agreement specifies that title to the b covered by the agreement is in the hands of Taxpayer "as soon as the [crops] have a potential existence." Section 1. However, risk of loss remains with the member until a crop is delivered to Taxpayer. Section 1. The member agrees to deliver the crops "at the earliest reasonable time after harvesting at such places as the Association may direct." Section 4. Products are inspected at the time of delivery, and "any loss that the Association may suffer on account of inferior or damaged condition of products at delivery" is borne by the member. Section 5.

Section 3 of the marketing agreement provides:

"(3) The association agrees to market either in the natural or processed state, such products, together with the products delivered by other Producers, and to, pay over ratable the net amount received there from, as payment in full to the Producer. After making deductions to cover:

Marketing $

: $ p/unit or prevailing rate"

The charges for marketing and are adjusted from time to time. Currently, the marketing charge is $ per package.

All of the b that Taxpayer markets for its members is marketed fresh. Taxpayer's marketing activities with respect to its members' b fall into three principal categories:

For some product sales, Taxpayer provides a marketing-only function. Members grow, harvest and then pack these products at their own facilities. Taxpayer then markets these products for its members. For the most recent year, this category of product sales accounted for approximately percent of Taxpayer's product sales.

For well over half of its product sales, Taxpayer receives, handles and , markets and ships the b. The b is grown, harvested and packed by members and then delivered to Taxpayer. There it is , a process necessary to preserve quality and prolong storage life). Taxpayer then markets the product. Products can be shipped from Taxpayer's by truck or by rail. For the most recent year, this category of product sales accounted for approximately percent of Taxpayer's product sales.

Taxpayer processes some of the crops that are delivered to the facility. Processed products account for about percent of Taxpayer's product sales.

While Taxpayer's marketing agreement permits it to commingle its members' b as part of its marketing of the b, Taxpayer does not do so except for b that it processes. For each sale (other than processed products), Taxpayer is able to specifically identify the member who grew the crops that were sold. As a result, it can, and does identify the proceeds from each sale (other than processed products) to one of its members. This is possible because of the limited number of members Taxpayer serves. The crops are sold fresh and packing largely takes place at its members' facilities.

Because direct tracing is possible, Taxpayer generally does not pool, but rather returns to each member the actual amount received for the member's product, less a charge for a share of marketing and, where appropriate, costs.

- For product sales where Taxpayer's only activity is marketing the products, Taxpayer pays the producer the amount that it receives for the product less a per package marketing charge, which is currently $. This marketing charge is designed to cover an allocable share of Taxpayer's operating and overhead expenses.

- For product sales where Taxpayer handles, and markets the products, Taxpayer pays the producer the amount that it receives for the product less the $ per package marketing charge and a charge, which is currently $ per package. Here, as well, the marketing and charges are designed to cover an allocable share of Taxpayer's operating and overhead expenses.

On days where the same kind of product (e.g.,) is purchased from several members and resold to several different customers at different prices, Taxpayer figures the payment to the members based on the lowest price. The difference is retained by Taxpayer and gets distributed among all members as a patronage dividend. This limited pooling is done to avoid questions as to whether one member was favored over another in deciding whose b went to the customers paying the higher price on that day.

Some of the b members deliver is not sold immediately to customers, but rather is used for processing. When this is done, members are paid a market amount for the b used for processing, less normal marketing and charges. The market amount is determined on the day the products are selected for further processing. For internal accounting purposes, members are treated as if they had sold that b for the market price. Any value-added profit as a result of processing is shared as a patronage dividend distribution as described below.

The amounts that Taxpayer pays to its members for their products are the amounts referred to in this ruling as "crop payments." For purposes of this ruling, the term "crop payment" does not include amounts paid nonmembers for their b. It also does not include any patronage dividends paid to members For its fiscal year ended

, Taxpayer's crop payments to members totaled approximately $ million.

Taxpayer's standard marketing agreement provides that it will "make such advances to the Producer on such products delivered hereunder as in the discretion of its manager may be justified by marketing conditions." Section 2. Taxpayer settles with members on a weekly basis, and pays amounts due to members for their crops several weeks later in cash by check. It normally takes Taxpayer 25 to 30 days to collect amounts due from customers, which is why Taxpayer's payments to members are made several weeks after the weekly settlement

Taxpayer is authorized by its Bylaws to hold back a retain. Article V, Section 7 of the Bylaws provides:

> "SECTION 7. RETAINS. The Board of Directors shall determine and fix the amount to be assessed against and collected upon the products of the members and other patrons of the Association marketed through this Association for capital purposes provided that the deductions made from proceeds of sale of members[‘] products for capital shall not exceed cents per package."

Taxpayer holds back $ per package as a retain. Historically, this retain was held back for working capital, and members were paid the amount held back in cash before the end of the year. Starting for the fiscal year ended , part ($ per package) of the retain is being held back for seasonal working capital and is paid in cash before the end of the year as in the past. The remainder ($ per package) is now being held back to provide long-term capital to Taxpayer, and members are being given Class B common stock to evidence that amount. The Class B common stock distributed for this purpose is a "qualified per-unit retain allocation certificate."

For purposes of this ruling, Taxpayer regards its crop payment to be equal to the net amount paid to members before the retain. References in this ruling to "crop payments in money" are to the net amounts paid in cash several weeks after each weekly settlement and to the portion of the retain held back for working capital and paid in cash before year end.

In all cases, Taxpayer purchases the b it markets from its members and then resells the b to customers. The transactions are treated as purchases and sales for purposes of Taxpayer's audited financial statements and for tax purposes. Taxpayer normally does not have crops on hand at year end because its b is sold fresh and its fiscal year end ( ) is during the off-season when members' crops are not being harvested. Thus, Taxpayer normally does not have inventories at year end.

Section of the Act obligates associations organized under the Act to distribute net earnings on a patronage basis. Taxpayer is organized under the Act.

Consistent with the Act, Taxpayer's Bylaws provide for the payment of patronage refunds to members:

> "SECTION 1. RIGHTS AND DETERMINATIONS. All net income or net margins of the Association attributable to business done for or with members shall be refunded on a patronage basis to the members who shall have contributed to the business of the Association in proportion to the volume or value of products contributed by the respective members. Such refunds may be in cash, revolving fund certificates, refund certificates, Class B Common Stock or any combination thereof as may be determined by the Directors each year. …" Bylaws Article X, Section 1.

In accordance with this provision, Taxpayer allocates and distributes its net earnings from business done with or for members each year to its members as patronage dividends. For this purpose, net earnings are determined treating crop payments to members as cost of goods sold.

For its fiscal year ended , Taxpayer paid $ of patronage dividends to its members, 20 percent in cash and 80 percent in shares of Class B common stock.

Taxpayer has treated crop payments to members made each year in cash pursuant to the marketing agreements as "purchases" for tax purposes and reported them on Schedule A, Line 2 of its Form 1120-C. Taxpayer has not reported crop payments to members as "per-unit retain allocations paid in money" and therefore has not reported them on Schedule A, Lines 4a or 4b of its Form 1120-C.

Taxpayer does not normally have b on hand at its fiscal year end and therefore does not have crops in inventory for financial statement or for tax purposes at year end. As a consequence, while crop payments have been treated as "purchases" for tax purposes, none have entered into the determination of inventories at year end.

Taxpayer has treated patronage refunds paid in cash and written notices of allocation pursuant to its Articles of Incorporation and Bylaws as "patronage dividends" and therefore has reported them on Schedule H, lines 3a and 3b of its Form 1120-C.

Taxpayer did not add crop payments paid in cash to members as part of its computation under section 199 of the Code in its tax return for its fiscal year ended and prior years, but it did add back its patronage refunds. In the past, Taxpayer passed the portion of its section 199 deduction that it could not use on its own tax return through to members.

Recent developments have caused Taxpayer to reconsider how it should treat its crop payments in cash to members for purposes of its section 199 computation. Taxpayer now believes that such payments should be classified as "per-unit retain

allocations paid in money." Taxpayer is requesting to obtain confirmation of that conclusion.

Taxpayer plans to change the reporting on its tax return for crop payments, reporting crop payments in cash and in Class B common stock on lines 4a and 4b of Schedule A, rather than on line 2. In addition, Taxpayer plans to treat crop payments in cash to members as per-unit retain allocations paid in money for purposes of computing its section 199 deduction commencing with its fiscal year ended (which return has not yet been filed). Taxpayer does not intend to modify its Articles of Incorporation, Bylaws and marketing agreement in any manner to change the labels placed upon its crop payments. For reasons set forth below, it is Taxpayer's view that such changes are not necessary since the definitions in the Code focus on substance and not labels.

Taxpayer will make certain that it does not exclude or deduct any crop payments twice on its tax return or add back any crop payments twice in its section 199 computation. The crop payments to members that Taxpayer plans to add back in its section 199 computation for a year will equal those deducted on its tax return for the year as costs of goods sold that relate to products marketed during the year.

Taxpayer may use all of the resulting section 199 deduction on its own return, pass through all of the resulting section 199 deduction to growers, or use part and pass through part of the deduction.

B. RULINGS REQUESTED

1. Crop payments to members constitute "per-unit retain allocations paid in money" within the meaning of section 1382(b)(3) of the Code.

2. For purposes of computing its section 199 domestic production activities deduction, Taxpayer's qualified production activities income and taxable income should, pursuant to section 199(d)(3)(C) of the Code, be computed without regard to any deduction for crop payments to members.

Nonexempt subchapter T cooperatives are permitted to exclude or deduct distributions to patrons that qualify as per-unit retain allocations or patronage dividends, provided the distributions 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 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 qualified production activities income (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., its members’ b).

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. For most crop sales, what members receive for their crops depends upon what Taxpayer receives for the crops less a deduction to cover a share of Taxpayer’s costs. For crops set aside to be marketed as processed products, Taxpayer pays members a current market price for the crops. To the extent that Taxpayer has net earnings from business done with or for members (treating crop payments as cost of goods sold), those net earnings are shared by members as patronage dividends.

The question presented in this ruling is whether the crop payments made by Taxpayer to members 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 crop payments in the section 199 computation. If the crop payments to members 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' section 199 computations. If the crop payments to members 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' 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.

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

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

First, Taxpayer's crop payments to a member are paid "pursuant to an agreement," namely the particular marketing agreement. Reporting crop payments as per-unit retain allocations paid in money in box 3 of Form 1099-PATR demonstrates that Taxpayer and its patrons agreed to treat crop payments as per-unit retain allocations paid in money.

Second, Taxpayer's crop payments to a member are made "with respect to products marketed for him," namely, the crop delivered by the member for marketing by Taxpayer. As described above, Taxpayer markets the crop it acquires from members, and members share in Taxpayer's net earnings from its marketing activities in the form of patronage dividends.

Third, the amount of the crop payments to each member "is fixed without reference to the net earnings" of Taxpayer since, at the time the payments are made, Taxpayer's actual net earnings for the year are neither known nor determinable.

While per-unit retains are often made on the basis of a specified amount per unit of product marketed, what is important is that they not be made with respect to net earnings. Rev. Rul. 68-236, 1968-2 C.B. 236, provides that "to constitute a per-unit retain allocation, the allocation need not be made strictly on the basis of a specified amount per-unit of product marketed provided it is made with respect to products marketed for the patron and not with respect to the net earnings of the organization. Whether an allocation meets the foregoing description will be a question of fact."

The fact that all members do not receive the same payments for their crop (i.e., that Taxpayer does not pool) does not mean that crop 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 crop 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 crop 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 crop is sold, the cost of goods sold mechanism associated with inventory must be adjusted to reflect the deductions allowable under subchapter T of the Code. Specifically, cooperatives need to include the per-unit retain allocations in inventory cost for purposes of making inventory and section 263A of the Code computations and then adjust the ending inventory and cost of goods sold to prevent double deduction of the per-unit retain allocations. The adjustments can be made to either the inventory or the line item deduction for the per-unit retain allocations. In other words, if the per-unit retain allocations are deducted on a deduction line in the cooperative's tax return, they should be removed entirely from the ending inventory and cost of goods sold computed for the tax year. Alternatively, if the per-unit retain allocations are not deducted on a deduction line in the tax return, the per-unit retain allocations reflected in the ending inventory should be removed and included in the cost of goods sold amount for that tax year. This procedure will allow the cooperative to deduct the per-unit retain allocations once while also preserving the integrity of its section 263A calculation.

For the reasons described above, Taxpayer's crop payments to members 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. 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 also 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. Crop payments to members constitute “per-unit retain allocations paid in money” within the meaning of section 1382(b)(3) of the Code.

2. For purposes of computing its section 199 domestic production activities deduction, Taxpayer’s qualified production activities income and taxable income should, pursuant to section 199(d)(3)(C) of the Code, be computed without regard to any deduction for crop payments to members.

The conclusions set forth in this ruling address only purchases that are per-unit retain allocations paid in money as they relate to crops marketed by the cooperative during the taxable year and does not apply to purchases of crops that remain in inventory at year end. No opinion is expressed or implied regarding the application of any other provision in the Code or regulations.

This ruling is directed only to the taxpayer that requested it. Under section 6110(k)(3) of the Code it may not be used or cited as precedent. In accordance with a power of attorney filed with the request, a copy of the ruling is being sent to your authorized representative.

Sincerely yours,

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

cc: