Internal Revenue Service

Number: **201152006**
Release Date: 12/30/2011

Index Number: 1382.00-00, 199.06-00

Department of the Treasury
Washington, DC 20224

Third Party Communication: None
Date of Communication: Not Applicable
Person To Contact:
, ID No.
Telephone Number:

Refer Reply To:
CC:PSI:B05
PLR-112885-11
Date:
September 21, 2011

LEGEND:

Taxpayer =

State A =

Area =

LLC =

Agreement =

b =

c =

Dear

This is in response to a request for rulings dated March 24, 2011, 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 organized as a cooperative corporation under the laws of State A. Taxpayer is a marketing cooperative serving c producers located in Area. Taxpayer qualifies as a section 521 cooperative having received a determination letter from the Internal Revenue Service confirming that status dated .

In , Taxpayer and several large independent c producers formed a limited liability company now known as LLC. LLC was formed to build and operate a state-of-the-art c processing plant. The plant is able to process and over b per day when in full production. All of the products produced at the plant are marketed by under an agreement between the two companies entered into in .

Each of the original members of LLC entered into an Agreement with LLC in . Under the Agreements each member of LLC commits to deliver to LLC a number of b equal to its ownership interest in LLC times a target number of b required to operate the plant efficiently. Taxpayer currently is the owner of a % interest in LLC, and it is committed to deliver b to LLC each year.

Taxpayer is the only cooperative member of LLC. Unlike the other members of LLC, which are each large b producers, Taxpayer does not itself produce b. Taxpayer's members do, and so Taxpayer has, in turn, entered into Uniform Marketing Agreements ("UMAs") with its members to assure that its obligations under the Agreement are met. While individually each of Taxpayer's members is too small to have direct access to LLC, collectively, operating through Taxpayer, they are large enough to have a relationship with LLC like that of the large producers that are direct members of LLC.

Taxpayer is organized as a cooperative corporation pursuant to Sections of the State A Statutes. These sections set forth the basic requirements for associations organized as cooperative corporations under State A law. 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 et seq.).

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 ."

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."

Section authorizes a cooperative to contract with members and provides for liquidated damages for breach of a marketing agreement:

"The contracts mentioned in section may require the members to sell, for any period of time not over five years, all or a stipulated part of their specifically enumerated products through the association …, but in such case a reasonable period during each year after the first two years of the contract shall be specified during which any member, by giving notice in prescribed form, may be released from such obligation thereunder. … In case it is difficult or impracticable to determine the actual amount of damage suffered by the association or its members through such failure to comply with the terms of such contract, the association and the members may agree upon a sum to be paid as liquidated damages for the breach of the contract, the amount to be stated in the contract."

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

"(a) To investigate, facilitate and develop [ ] processing and [c] marketing opportunities for its members;

(b) To coordinate or provide storage, handling, grading, processing, marketing and shipping services for its members;

(c) To coordinate, develop or provide services for its members and the [c] products produced by its members; and

(d) For any other lawful purpose.

To this end, the business and activities of this Cooperative shall be conducted on a cooperative basis." (Articles of Incorporation, Article II, Section 2.1).

Taxpayer is organized with capital stock. Articles of Incorporation, Article IV. Three classes of capital stock are authorized – common stock (with a par value of $.001

per share), Class A preferred stock (with a par value of $.001 per share) and Class B preferred stock (with a par value of $.001 per share). Articles of Incorporation, Article IV, Section 4.1. Currently, all outstanding shares of Class A preferred stock are owned by members of Taxpayer. There are no shares of Class B preferred stock outstanding.

Only "producers of agricultural products and associations of such producers" are eligible to be members and owners of common stock. Articles of Incorporation, Article IV, Section 4.2(a). Taxpayer's Bylaws provide that in order to be a member of Taxpayer, a person must be (i) a producer of agricultural products or an association of such producers, (ii) who patronizes Taxpayer, (iii) is approved by the Board of Directors, (iv) purchases a share of common stock and the requisite number of share of Class A preferred stock, (v) enters into a UMA, and (vi) meets other requirements set from time to time by the Board. Bylaw 1, Section 1.01. Taxpayer currently has c producers that own shares of common stock, that patronize Taxpayer, and that have entered into UMAs with Taxpayer. These persons are the persons referred to in this ruling as Taxpayer's "members."

Taxpayer is organized and operated on a one-member, one-vote basis. Each member is entitled to one vote in the affairs of the cooperative regardless of the number of shares of common stock owned. Articles of Incorporation, Article IV, Section 4.2(a). Taxpayer has a policy that affiliated members are entitled to only one vote, notwithstanding that each might own a share of common stock. Because several members are affiliated, Taxpayer's actual number of voting members is .

While common stock is described as "common," it does not bear dividends. Articles of Incorporation, Article IV, Section 4.2(b). Upon dissolution, it is senior to the rights of patrons' equities and the rights of member patrons to share in residual assets. Bylaw 9, Section 9.02. Holders are limited to receiving the value for which the shares were issued. Bylaw 9, Section 9.02(3). Common stock is non-transferable and cannot be pledged. Articles of Incorporation, Article IV, Section 4.2(b).

Taxpayer is what is commonly referred to as a "closed cooperative." Taxpayer currently has the obligation under its Agreement to deliver b per year to LLC for and marketing. To balance members' supply of b with the number of b it is obligated to deliver to LLC, Taxpayer has created delivery rights through the UMAs. Each delivery right gives a member of Taxpayer the right and the obligation to deliver one b per year to LLC under Taxpayer's Agreement, sharing in Taxpayer's distributive share of LLC's earnings on a patronage basis. The aggregate number of delivery rights is set to maintain a balance between the b Taxpayer has an obligation to deliver to LLC each year under its Agreement and the numbers of b members have an obligation to deliver to LLC each year under Taxpayer's Agreement. Thus, the aggregate number of b Taxpayer's members have committed to deliver to LLC under the UMAs, namely , equals the number of b Taxpayer is committed to deliver to LLC under its Agreement.

The burden of capitalizing Taxpayer is shared by members in proportion to delivery rights. Members of Taxpayer are required to purchase one share of Class A preferred stock for each delivery right. For example, a member who wants to enter into a UMA with Taxpayer to deliver 10,000 b per year to Taxpayer for marketing through LLC is required to purchase 10,000 shares of Class A preferred stock. There currently are shares of Class A preferred stock issued and outstanding.

Taxpayer's Class A preferred stock is subject to the same ownership restrictions as common stock. Articles of Incorporation, Article IV, Section 4.3. It is nonvoting. Articles of Incorporation, Article VII, Section 3. It is not entitled to dividends. Articles of Incorporation, Article IV, Section 4.3. In the event of dissolution, holders of shares of Class A preferred stock are entitled to receive the consideration paid for the shares and no more. Shares of Class A preferred stock are transferable only to eligible persons and then only with the approval of the Board of Directors.

As a cooperative, Taxpayer is required by its Articles of Incorporation to distribute its net income each year (including its distributive share of income from LLC) to members (and nonmember patrons, if any) as patronage dividends:

> "The net income of this Cooperative in excess of dividends on equity capital and additions to reserves shall be distributed to members and nonmember patrons annually or more often on the basis of patronage and the records of this Cooperative may show the interest of members and nonmember patrons in the reserves. … The net income or net loss of this Cooperative or any allocation unit may be determined by including the cooperative's proportionate share of the net income or loss of other entities in which the cooperative owns an equity interest. The foregoing provisions of this Article shall be implemented as more particularly provided in the Bylaws of this Cooperative." (Articles of Incorporation, Article V).

Bylaw 7 outlines in greater detail Taxpayer's obligation to pay patronage dividends each year. Bylaw 7, Section 7.01 provides:

> " . This cooperative shall be operated upon the cooperative basis in carrying out its business within the scope of the powers and purposes defined in the Articles of Incorporation. Accordingly, the net income of this cooperative in excess of amounts credited by the Board of Directors to capital reserves and amounts of dividends, if any, paid with respect to equity capital shall be accounted for and distributed annually on the basis of allocation units (as authorized by the Board of Directors) as provided in this bylaw. In determining the net income or net loss of this cooperative or its allocation units, there shall be taken into account this cooperative's share of the net income or net loss of any unincorporated entity (including without limitation, limited liability

companies and partnerships, whether general or limited) in which it owns an equity interest, patronage dividends distributed by other cooperatives of which this cooperative is a patron and, to the extent prospectively determined by the Board of Directors, its share of the undistributed net income or net loss of any corporation in which this cooperative owns an equity interest…."

The Bylaws provide that "[u]ntil different allocation units are established by the Board of Directors, the entire business of this cooperative shall be considered one and the only allocation unit." Bylaw 7, Section 7.03. In accordance with this, Taxpayer currently determines patronage dividends using a single allocation unit.

The Bylaws provide guidance as to how to determine net earnings and then provide that net earnings from patronage business, less any amounts that are otherwise allocated in dissolution pursuant to Bylaw 9, "shall be allocated among the patrons … in the ratio that the quantity or value of the business done with or for each patron bears to the quantity or value of the business done with or for all patrons of the allocation unit." Bylaw 7, Section 7.05.

Patronage dividends may be distributed "in cash, capital stock, allocated patronage equities, revolving fund certificates, securities of this cooperative, other securities, or any combination thereof designated by the Board of Directors…" Bylaw 7, Section 7.07(b). Historically, Taxpayer has paid its patronage dividends in cash and written notices of allocation (referred to by Taxpayer as "patrons' equities" or "deferred" patronage).

Bylaw 7, Section 7.06 provides the Board of Directors with broad discretion in the event that a cooperative incurs a loss, including "[establishing] accounts payable by patrons of the allocation unit that incurs the net loss that may be satisfied out of any future amounts that may become payable by this cooperative to the patron" and "[canceling] outstanding Patrons' Equities."

In the event of dissolution, Article VI of the Articles of Incorporation and Bylaw 9, Section 9.02 provide that assets shall first be used to pay all of the debts and liabilities of Taxpayer. Assets then are distributed in the following order of priority: (i) to the holders of shares of Class B preferred stock an amount equal to the value of the consideration for which the shares were issued, (ii) to the holders of shares of Class A preferred stock an amount equal to the value of the consideration for which the shares were issued, (iii) to the holders of shares of common stock an amount equal to the value of the consideration for which the shares were issued, (iv) to the holders of Patrons' Equities (written notices of allocation) an amount equal to their stated dollar amount, (v) to holders of any certificates allocating nonpatronage earnings an amount equal to their stated dollar amount, and then (vi) to current member patrons in accordance with their credited interest in Capital Reserves. Any remaining assets are then to be allocated

among member patrons on a patronage basis "over the period as may be determined to be equitable and practicable by the Board of Directors."

When LLC was formed, Taxpayer and other members of LLC entered into Agreements. The Agreements have been amended on a number of occasions since the original Agreement was entered into in

Taxpayer's Agreement and the Agreements of the other members of LLC set forth the details of the obligation of Taxpayer (and Taxpayer's members) and of each other member of LLC to deliver and sell a specified number of b to LLC each year and of the corresponding obligation of LLC to purchase the b from Taxpayer (and Taxpayer's members) and from the other members of LLC. Section 3 of the Agreement. Currently the obligation of Taxpayer (and its members) under its Agreement is to deliver and sell b to LLC per year, and LLC's obligation is to purchase those b from Taxpayer (and its members).

Because the LLC plant needs constant deliveries on a daily basis throughout the year to operate efficiently, the Agreement establishes a framework for Taxpayer and the other members of LLC to work with LLC to schedule the delivery of b on a daily and weekly basis throughout the year. Section 4 of the Agreement. Taxpayer works with its members and with LLC to schedule the delivery of approximately truckloads of b to the LLC facility each week throughout the year. Producers are responsible for transporting (or arranging for transporting) the b to the facility.

LLC has the right to adjust any delivery schedules agreed to or to reduce the number of b to be delivered in any given week "to accommodate downtime or decreased capacities" at its plant. Section 4(c) of the Agreement.

The Agreement requires Taxpayer (and its members) to covenant and agree to produce b in accordance with a variety of best practices and standards. For instance, the b must be raised "in accordance with accepted practices of good [ ], management and ." The agreement contains provisions related to usage, safety, disposal of and , food safety, welfare, approved , , product marketing requirements, annual requirements, injection technology, handling certifications, country of origin labeling and requirements. Section 5 of the Agreement.

The purchase price for the b is determined based upon a formula described in Section 6 of the Agreement. This formula applies to all b delivered to LLC pursuant to the Agreements, whether the c producer is a large producer or a small producer. The base price per used in the formula is tied to the then applicable as reported in the . The price is adjusted by a matrix that reflects the average percentage of the b delivered. The b are inspected and

weighed when they are delivered to LLC's plant. Sections 4(f) and (g) of the Agreement.

The provisions of State A law under which Taxpayer is organized authorize cooperatives to enter into marketing agreements with members, and Taxpayer's Bylaws require that a producer enter into a marketing agreement as a condition of membership.

Taxpayer's UMAs are drafted with the intent of assuring that its members collectively will produce and deliver b to meet Taxpayer's obligation to deliver b per year to LLC under its Agreement. Each UMA obligates a member to deliver a fixed number of b each year. This number is specified in the box at the top right hand corner of the UMA. Section 1 of the UMA then provides:

> The Producer agrees to deliver to [LLC] as part of the Cooperative's delivery obligation to [LLC] the number of 'committed [b]' stated above on an annual basis. [LLC] may reduce the Committed [b] by giving written notice, as applicable, at any time in any year to all members delivering b to [LLC] on a pro rata basis if [LLC] determines in its sole discretion that the actual number of b needed by [LLC] is a lesser amount."

Cumulatively, the number of committed b established in all of the UMAs is .

Members are required to deliver b directly to LLC. However, LLC looks to Taxpayer, as the signatory of the Agreement, to arrange for delivery of the b in accordance with the scheduling needs of LLC. It is Taxpayer's responsibility to work with its members so that this is accomplished.

Members delivering b to LLC under the UMAs are paid what Taxpayer is paid for the b under the Agreement less a fee (initially set at $) per b that is paid to Taxpayer. Section 7 of the UMA. Taxpayer also has the right to retain a portion of the payment for its capital.

When members of Taxpayer enter into a UMA, they also enter into the Taxpayer Producers' Cooperative Assignment of b Procurement Agreement and Member Delivery and Acknowledgement Agreement ("the Assignment Agreement").

LLC financed the construction of its plant in part with borrowed funds, and the lenders were concerned that the plant have an assured source of b. That assured source of b comes through the Agreements. In the case of the Agreement with Taxpayer, the lenders wanted to make certain that LLC could proceed not only against Taxpayer in the event of the breach of the Agreement, but also against Taxpayer's members since collectively the members' net worth is greater than that of Taxpayer and they were the ultimate source of the b Taxpayer was committed to deliver. Thus, the lenders insisted that Taxpayer's members each enter into an Assignment Agreement,

which allows LLC to proceed not only against Taxpayer, but also against Taxpayer's members in the event of a default by Taxpayer and the members.

Each individual member of Taxpayer is not responsible for the entire Agreement, but LLC may enforce its rights under the Agreement directly against members proportionately. Section 2 of the Assignment Agreement.

When LLC was being formed, the other potential members were all large producers who viewed including a number of small producers in the venture as increasing the complexity and cost of operations. Small producers generally do not have the capacity to deliver b throughout the year in accordance with LLC's production needs. The other potential members were willing to accept an association like Taxpayer as a member of LLC provided the association was willing to come up with the required capital contribution and sign an Agreement just as they did, and provided the association was willing to take the responsibility for coordinating the operations of small producers so that they collectively acted like a single large producer.

Taxpayer coordinates the efforts of its members through several different means. First, it raised the money necessary to make the required capital contribution to LLC by selling members shares of Class A preferred stock. Each member of Taxpayer is required to own one share of Class A preferred stock for each b the member commits to deliver under the UMA. Second, Taxpayer entered into UMAs with its members obtaining collective commitments from them to raise and deliver the b necessary for Taxpayer to meet its obligations under the Agreement.

Even though Taxpayer was the signatory of the Agreement, LLC's lenders wanted LLC to have the ability to proceed directly against the members of Taxpayer (and not just against Taxpayer) in the event that there was a failure to meet delivery obligations under the Agreement or some other default. Thus, the Assignment Agreements were developed, and each member of Taxpayer is required to enter into an Assignment Agreement taking partial direct responsibility for a portion of the Agreement.

The Assignment Agreements do not eliminate Taxpayer's over-all responsibility under the Agreement, but rather simply backstop that responsibility. Taxpayer remains the party with authority to approve amendments, waivers, modifications or consents under the Agreement. Assignment Agreement, Section 1. Taxpayer also remains the party to enforce rights under the Agreement in the event that LLC breaches its obligations under the Agreement. The Agreement gives Taxpayer a wide range of remedies should that occur. Section 10(a). These rights include the right to "resell the Market [b] in a commercially reasonable manner and recover from [LLC] the difference, if negative, between the sales price (plus any additional expenses incurred and less expenses saved) and the price to be paid under this Agreement, together with incidental and consequential damages, including attorneys' fees and expenses and any other expenses incurred in collection of such damages…" Section 10(a)(i).

The Agreement gives LLC a wide range of remedies if Taxpayer breaches the Agreement. See Section 10(b) of the Agreement. So, for instance, if Taxpayer fails to deliver b as obligated under the agreement, Section 10(b)(i) provides that LLC may "purchase [b] from a third party to replace the quantity of Market [b] not delivered by [Taxpayer] and recover Replacement Damages from [Taxpayer], together with incidental and consequential damages, including but not limited to an amount equal to the difference in the net margin to [LLC] if such replacement [b] are lighter than those Market [b] required thereunder or if such replacement [b] are of a lower percentage lean than those Market [b] required hereunder, attorneys' fees and expenses and any other expenses incurred in collection of such damages." Sections 10(b)(ii) through (vii) provide other possible remedies, and Section 10(c) provides that the "rights and remedies … shall be cumulative, nonexclusive and in addition to any rights now or hereafter granted under applicable law or otherwise and to which a party may be entitled at law or in equity."

These remain in place after the Assignment Agreement, though LLC is given other options. Thus, Section 3 of the UMA provides:

> "If Producer fails to deliver Committed [b] as provided in the [b] Procurement Agreement, [LLC] shall notify Producer and Cooperative. If the default is not cured as required by the [b] Procurement Agreement, <u>[LLC] shall charge the Cooperative with damages</u> and may offset damages against amounts due to Producer. <u>The Cooperative may, in its discretion, offset damages charged on account of Producer's default against Producer's equity, patronage allocations or accounts at the Cooperative's discretion</u> after notice to Producer of the Board meeting when any such offset will be determined." (emphasis added).

To protect Taxpayer, the UMAs provide various remedies to Taxpayer if the member fails to perform. Section 3 of the UMAs requires that if a member can not deliver [b] as required under the UMA, "the Producer must obtain the required [b] from another qualified source and deliver through the Cooperative to [LLC], just as if the [b] had been produced by the producer." If the Producer does not do so, then Taxpayer is authorized to obtain [b] in the name of the Producer "and may charge to the Producer all expenses, including, but not limited to, the price of the [b], shipping, reasonable attorneys' fees, and all incidental costs in obtaining and delivering the [b]; or in the alternative, the Cooperative may reallocate Producer's delivery rights to other [b] producers under the delivery terms of this Agreement and the [b] Procurement agreement."

To provide Taxpayer with further protection against the possibility that a member breach of the UMA could lead to liability for Taxpayer and its other members, Section 9 of the UMA provides:

> The Cooperative shall be entitled to injunctive relief or a decree of specific performance in the event of any breach of this Agreement. It is further agreed that for purposes of ascertaining damages under this Agreement for any failure of a Producer to deliver [b] or failure of a Producer to deliver [b] meeting the specifications in this Agreement or the [b] Procurement Agreement, the market value shall be the highest price for [b] determined during the 30-day period following the Producer's breach of this Agreement. … The Producer agrees to pay all reasonable legal costs and expenses, including attorneys' fees and court costs, incurred by the Cooperative in any action brought by the Cooperative against the Producer for any breach or threatened breach of this Agreement."

At various places in the Agreement and the UMA, Taxpayer is characterized as acting as an agent for its members. However, Taxpayer functions as more than an agent. Mere agents do not sign contracts as principals and are not directly responsible for breaches of those contracts. Agency language is sometimes used rather loosely in cooperative agreements when it is perhaps more accurate to say that a cooperative is acting in its own right as a organization that collectively represents its members.

While Taxpayer does not physically handle its members' b, Taxpayer is responsible for making certain that collectively its members deliver b in accordance with the terms of the Agreement. Taxpayer has the critical function of coordinating production and deliveries to make certain that there is no breach of the Agreement. Taxpayer's ability to handle this function so that its members collectively operate like a large producer is critical to making the arrangement possible.

Historically, LLC did not pay Taxpayer for the b delivered under the Agreement, but rather paid Taxpayer's members directly. That recently changed. In the past, direct payments were made for purpose of convenience to avoid making a payment to Taxpayer, with Taxpayer then turning around and making payments to producers, adding a delay in producers getting the amounts to which they are entitled.

While the payments were structured as going from LLC to Taxpayer's members, Taxpayer always considered that if, for some reason, LLC failed to pay Taxpayer's members for b they delivered to LLC in accordance with the UMA, Taxpayer could be responsible for paying for the b under Section 7 of the UMA. This risk is mitigated by the bond that LLC is required to maintain under to assure payment. Also, Taxpayer has a number of remedies in the event that LLC breaches the Agreement, and failure to pay would be a breach. In particular, Section 10(a)(ii) of the Agreement provides:

> "(ii) with respect to any failure by [LLC] to pay for Market [b] in accordance with this Agreement, in addition to pursuing other rights and remedies set forth in paragraph 10(a) hereof, [Taxpayer] may withhold delivery of

Market [b], and/or sell the Market [b] in a commercially reasonable manner and recover from Processor the difference, if negative, between the sale price (plus any additional expenses incurred and less expenses saved) and the price to be paid under this Agreement, together with incidental and consequential damages, including attorneys' fees and expenses and any other expenses incurred in collection of such damages…"

Moreover, Taxpayer retained certain rights to the payment stream even though payment was being made directly from LLC to Taxpayer's members. For instance, Taxpayer has the right to charge members a fee of $ per marketed b. Historically this fee was paid by LLC to Taxpayer and subtracted out of payments by LLC to members. Section 7 of the UMA and Section 3 of the Assignment Agreement.

In addition, in Bylaw 10, Section 10.10, Taxpayer retains the right to retain a portion of the b proceeds for capital purposes:

> This cooperative may require investment in its capital in addition to the investments from retained patronage. These investments shall be direct capital investments from a retain on a per unit basis of the products purchased from its members. The unit retention, if required, shall be made on all products delivered, in the same amount per unit and shall at no time become part of net annual savings available for patronage. Each member, by continuing to be such, agrees to invest in the capital of this cooperative as prescribed in this Bylaw 10."

While Taxpayer has not held back a portion of the proceeds for capital, if it had decided in the past to do so that would have come out of the b payments that LLC was making to Taxpayer's members.

In addition, the Agreement gives LLC the right to offset amounts to be paid for the b against any amounts that Taxpayer may owe to LLC. Section 10(b)(ii) of the Agreement. Moreover, in the Assignment Agreement, members acknowledge that:

> "… debts of [Taxpayer] to [LLC] that could be offset if Taxpayer delivered [b] to [LLC] can be offset against [LLC]'s payment to Member for [b] delivered to [LLC]." Assignment Agreement, Section 3.

Historically, Taxpayer has not reported member b deliveries as sales by members to Taxpayer and then as sales by Taxpayer to LLC for either accounting or tax purposes. Rather, Taxpayer reported the net amount received from LLC as income.

However, during the past year, this was changed. LLC is now paying Taxpayer directly for the b delivered to it under the Agreement, and Taxpayer is paying its members directly for the b delivered to LLC. This change was effective ,

and was reflected in the Agreement for Indemnification and Right of Setoff and the Agreement of Waiver of Prompt Payment which each member entered into with Taxpayer.

As a result of this change and of its re-evaluation of the legal relationships between members and Taxpayer and Taxpayer and LLC, Taxpayer's accountant and tax return preparer plans to begin treating the deliveries as sales by members to Taxpayer and as sales by Taxpayer to LLC for financial reporting and tax purposes, effective on . These payments are what is referred to in this ruling as the "b payments." During the period through , Taxpayer's b payments to members totaled $.

Taxpayer plans to treat the b payments made to members for their b on and after , as per-unit retain allocations paid in money. Taxpayer reported those payments in box 3 of the Form 1099-PATRs provided to members for . Taxpayer plans to add back the b payments in its section 199 computation for tax purposes for its fiscal year ended , and for subsequent years. At the time of submission of the ruling request, Taxpayer had not yet filed its tax return for the fiscal year ended .

Taxpayer's ruling was filed to request confirmation that the b payments made on and after are per-unit retain allocations paid in money which can be added back in the section 199 computation.

Taxpayer does not intend to modify its Articles of Incorporation, Bylaws, the UMA or the Assignment Agreement in any manner to change the labels placed upon its b payments. Taxpayer will make certain that it does not exclude or deduct any b payments twice on its tax return or add back any b payments twice in its section 199 computation. The b 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 cost of goods sold that relate to b sold to LLC 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.

Based on the foregoing, Taxpayer requests the following rulings:

1. The b 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 b payments to members.

Exempt section 521 and nonexempt subchapter T cooperatives are permitted to exclude or deduct distributions to patrons that qualify as per-unit retain allocations or as 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 section 521 farmers’ 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. Taxpayer purchases b from members and markets the b. What members receive for their b depends upon what Taxpayer receives for the b (as determined by the formula contained in the Agreement) less a deduction to cover a share of Taxpayer's costs.

The question presented in this ruling is whether the b payments made by Taxpayer to members for b qualify as per-unit retain allocations paid in money within the meaning of section 1388(f) of the Code.

Under section 199 of the Code and section 1.199-6 of the regulations, the answer to this question determines who gets to include the b payments in the section 199 computation. If the b 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 b 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.

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

Taxpayer's b 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."

This meeting of the minds between the cooperative and the member or patron must be evidenced by clear and timely evidence showing that the payment was a per-unit retain allocation and not sale proceeds, and, subsequent, consistent treatment of the payment as a per-unit retain allocation by the cooperative.

First, Taxpayer's b payments to a member are paid "pursuant to an agreement," namely the UMAs. The agreement required in section 1388(f) of the Code is an agreement between Taxpayer and the member that the amount is a per-unit retain

allocation and does not represent proceeds from a sale to the cooperative. Reporting b payments as per-unit retain allocations paid in money in box 3 of Form 1099-PATR demonstrates that Taxpayer and the member agreed to treat b payments as per-unit retain allocations paid in money and not sales.

Second, Taxpayer's b payments to a member are made "with respect to products marketed for him," namely, the b delivered by the member to LLC under the UMA. As described above, Taxpayer arranged for the marketing of the b by entering in the Agreement with LLC and then entering into UMAs with members that allow them to deliver b to LLC under Taxpayer's Agreement.

Third, the amount of the b 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 b (i.e., that Taxpayer does not pool) does not mean that b 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."

Whether or not Taxpayer is pooling is a moot issue for purpose of this ruling because its b payments will 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 b is sold, the cost of goods sold mechanism associated with inventory must be adjusted to reflect the deductions allowable under subchapter T of the Code. Specifically, cooperatives need to include the per-unit retain allocations in inventory cost for purposes of making inventory and section 263A of the Code computations and then adjust the ending inventory and cost of goods sold to prevent double deduction of the per-unit retain allocations. The adjustments can be made to either the inventory or the line item deduction for the per-unit retain allocations. In other words, if the per-unit retain allocations are deducted on a deduction line in the cooperative's tax return, they should be removed entirely from the ending inventory and cost of goods sold computed for the tax year. Alternatively, if the per-unit retain allocations are not deducted on a deduction line in the tax return, the per-unit retain allocations reflected in the ending inventory should be removed and included in the cost of goods sold amount for that tax year. This procedure will allow the cooperative to deduct the per-unit retain allocations once while also preserving the integrity of its section 263A calculation.

For the reasons described above, Taxpayer's b 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.

Accordingly, we rule as requested that:

1. The b 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 b payments to members.

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: