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LEGEND:

Taxpayer =

State A =

State B =

b =

c =

Agreement =

Dear

This is in response to a request for rulings dated July 20, 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 a farmers' cooperative organized as a cooperative association under the laws of State A. Taxpayer was established in to assist owners of b to market their b. The b owners Taxpayer serves all possess the same goal – to derive a fair price when it comes time to sell their b. Most of the owners Taxpayer serves are c

farmers who use Taxpayer to sell and c when they are retired from the . Taxpayer also serves owners who and market other kinds of b.

In the beginning, Taxpayer had collection points allowing b to be taken by rail to the b market in Taxpayer also marketed b by Agreement. Starting in , Taxpayer began operating . Today Taxpayer operates at locations in State A and in State B. In addition, Taxpayer provides b owners with a variety of other services related to b production, including financing (through a wholly-owned subsidiary) and risk management services.

Taxpayer is organized on a federated basis. Taxpayer's members are local cooperative associations (referred to in this ruling as "member associations"). With and through them, Taxpayer serves over b owners, each of whom is affiliated with and a patron of one of the member associations. Each member association serves its patrons (members and nonmembers alike) on a patronage basis, so b owners marketing b through the member associations and Taxpayer are collectively referred to as "eligible patrons."

In , Taxpayer marketed over $ million worth of b. Of these, approximately $ million were b which Taxpayer marketed by Agreement and approximately $ million were b sold through Taxpayer's .

Taxpayer is organized as a cooperative corporation under the State A Cooperative Association Act (the "Act"). Under the Act, cooperatives can be organized on a stock or nonstock basis. Taxpayer is organized with stock. Taxpayer is authorized to issue Common Stock, Class A Preferred Stock and Class B Preferred Stock.

- Taxpayer's Common Stock is its membership stock. Common Stock may be issued only to cooperative associations composed of b producers, either as or . Articles of Incorporation, Article VII, Section 3(a). Common Stock is not entitled to dividends. Articles of Incorporation, Article VII, Section 3(d). Upon liquidation, holders of Common Stock are entitled to receive par value ($50 per share) and no more. Articles of Incorporation, Article VII, Section 3(e).

- The shares of Class A Preferred Stock are nonvoting. Holders are entitled to a noncumulative dividend of seven percent (7%) of par value, the amount originally paid for the stock. Upon liquidation, holders of shares of Class A Preferred Stock are entitled to receive par value and no more. Articles of Incorporation, Article VII, Section 1. These shares were issued over the years to raise capital necessary to finance Taxpayer's operations, and are largely held by association members and eligible patrons.

- The shares of Class B Preferred Stock are nonvoting. Holders are entitled to a noncumulative dividend equal to the prime rate less 25 basis points,

> but not less than three percent (3%) and not more than seven percent (7%) of par value. Upon liquidation, holders of shares of Class B Preferred Stock are entitled to receive par value and no more. Articles of Incorporation, Article VII, Section 1. These shares also have been issued to raise capital necessary to finance Taxpayer's operations and are largely held by association members and eligible patrons.

Taxpayer is democratically controlled by its member associations (and the members of the member associations, which are referred to by Taxpayer as the "producer members"). Taxpayer's governance reflects the fact that it is a federated cooperative. Applying a simple one-member, one-vote approach to the governance of federated cooperatives can sometimes lead to anomalous results, particularly where some association members of a federated cooperative have significantly more members than other association members or do significantly more business with the federated cooperative than others. While the Act generally provides that each member of a cooperative will be entitled to one vote, it also provides that in the case of a federated cooperative "… the articles may permit either or both (a) a member association to cast additional votes not exceeding a number equal to its membership, [and/or] (b) a cooperative whose member-patrons include other associations to base voting in whole or in part on a patronage basis." Section).

Article VII, Section 3(b) of Taxpayer's Articles of Incorporation provides that each association member shall have one vote plus additional votes as provided in the Bylaws. The Bylaws provide for what Taxpayer describes as "look-through" voting. Bylaw 3, Section 2(A) provides that "[e]ach Common Stockholder shall possess one vote (the 'Member Vote') plus the number of votes as determined below (the 'Look-Through Votes') by reference to the individual members in good standing of the Common Stockholder (the 'Producer Members')." Bylaw 3, Section 2(B) then states:

> "With respect to each matter voted upon, each Common Stockholder shall possess a number of Look-Through Votes equal to the number of its Producer members[1] who voted on such matter at a duly convened membership meeting held by such Common Stockholder prior to, or contemporaneous with, the District Meeting to which the Common Stockholder is assigned. The Common Stockholder shall cast each Look-Through Vote in the same manner as the particular Producer Member cast such vote at the Common Stockholder's meeting."

Taxpayer has divided the territory it serves into ten districts. Bylaw 3, Section 3. To encourage greater producer member participation, Taxpayer holds ten district annual

1. For this purpose, it is up to each of the association members to decide who its producer members are, except no one may qualify as a producer member of an association member if he or she has not marketed at least one (1) of b through Taxpayer in the prior 12 months. Bylaw 3, Section 2(A). Producers are not permitted to be producer members of more than one association member. Bylaw 3, Section 2(A).

meetings each year instead of one centralized annual meeting. Bylaw 3, Section 4 provides that the district meetings "shall together constitute the annual membership meeting of" Taxpayer. The producer members of Taxpayer's member associations in each district are invited to attend the district annual meeting and to vote at that meeting. At these meetings, the producer member votes become the member associations' "Look-Through Votes."

Each district elects one of the ten directors that make up Taxpayer's Board, with the association members (the Common Stockholders) in each district casting their Member Votes and with the producer member votes at that meeting becoming the association members' "Look-Through Votes." Bylaw 3, Section 7. Matters subject to vote of the entire membership at an annual meeting are also voted on at the district annual meetings with the producer member votes becoming the association members' "Look-Through Votes." Bylaw 3, Section 4 provides:

> "In determining whether a particular matter has received the requisite number of votes, the votes cast at all of the district meetings shall be aggregated and such aggregate votes shall be the vote of the Common Stockholders…"

This approach to voting also applies to any special meetings that may be called. Special meeting may be conducted either on a district or on a centralized basis. Bylaw 3, Section 8. Through this "Look-Through Vote" mechanism, Taxpayer is democratically controlled by the persons it serves.

The Act requires cooperatives to apportion and distribute their net earnings on a patronage basis. See, Section . Sections 1 and 3 of Article VIII of Taxpayer's Articles of Incorporation provide:

> "1. Profits. The Cooperative shall be operated without profit. The Cooperative is obligated to its patrons, member and non-members alike, on a patronage basis, or bases, for all amounts, if any, received for agricultural products marketed and for supplies, goods and services procured or services performed for patrons, in excess of (1) advances to patrons for products to be marketed, (2) the cost of supplies, goods and services, and (3) a fair part of the general operating costs and expenses of the Cooperative properly chargeable to each type of commodity or service, including valuation reserves and dividends or interest on capital."

> "3. Net Income. It is the intention of the Cooperative to operate in such manner that there will be no net income, but if in any year a net income is realized it shall be distributed to the patrons, members and non-members alike, on a patronage basis.

a. The Cooperative may also establish and maintain such allocated reserves and revolving funds as may be provided for in the Bylaws."

Pursuant to the Act and its Articles of Incorporation and Bylaws, Taxpayer determines its net earnings each year and pays patronage dividends to its patrons. For this purpose, Taxpayer considers that its patrons are its association members since Taxpayer was originally established by its association members to assist them more effectively market the b of their patrons.

Taxpayer pays its patronage dividends based upon a single allocation unit, allocating the earnings among the member associations based upon the dollar value of the b marketed for patrons of each member association for the year compared to the total dollar value of the b marketed for patrons of all of the member associations during the year. For this purpose, Taxpayer counts the dollar value of all b marketed through Taxpayer whether by or Agreement.

The member associations are all cooperatives, whose articles of incorporation and bylaws provide that they will allocate their net earnings to their patrons on a patronage basis, treating both members and nonmembers alike. The member associations' net earnings include patronage dividends they receive from Taxpayer. Because all patrons of the member associations are eligible to share in patronage dividends, they are collectively referred to as "eligible patrons" in this ruling.

Taxpayer pays its patronage dividends to member associations in cash and patronage credits, which are "qualified" as that term is used in subchapter T of the Code.

In the event of dissolution, Taxpayer's Articles of Incorporation provide generally that assets will be distributed in the following order of priority: first, to pay all debts; second, to pay holders of Class A Preferred Stock an amount equal to the par value plus any dividends then accrued , but unpaid on such shares; third, to pay holders of Class B Preferred stock an amount equal to the par value; and fourth, to pay common stockholders and patronage credit holders an amount equal to par value or face value as the case may be. Articles of Incorporation, Article VII, Sections 1(c), 2(c), and 3(e). Finally, any remaining assets "shall go to patrons on a patronage basis for the immediate past twenty (20) fiscal years." Articles of Incorporation, Article VII, Section 3(e).

Taxpayer markets the b of the patrons of its association members in one of two ways – through sales and through Agreement sales.

About percent of the b that Taxpayer markets are marketed through that Taxpayer operates. Taxpayer operates both traditional and Internet .

Taxpayer operates traditional strategically located across State A and in State B. Regularly scheduled are held at these markets. A b owner that wishes to sell b at one of Taxpayer's is responsible for shipping b to the market. Taxpayer receives the b at the facility, them and them. Taxpayer generates a "dock-in slip" acknowledging receipt of the b from the owner on consignment for marketing. The b are then sold by public . The b owners may set minimum prices that must be met before a sale can be consummated, but they rarely do. When the gavel falls, the b is sold to the successful bidder, who is responsible for arranging transportation from the site after the sale.

The b marketed through Taxpayer's are consigned to Taxpayer for sale. While Taxpayer is never the owner or the purchaser of the b sold at , it is responsible for paying the owners for the b and collecting amounts due from the purchasers.

Taxpayer is regarded as a " " under the federal . As such, Taxpayer is subject to regulation by the

Taxpayer is required to register with , execute and maintain a reasonable bond as a measure of protection for b consignors, and establish and maintain a separate bank account designated as "Custodial Account for Proceeds." This is a special trust account designed to ensure payment to consignors. When consigned bare sold at , Taxpayer is required to pay the owners before the close of the next business day following the day of the , delivering to the owner a written account of such sale and a check for the net proceeds.

The process is similar when b are sold by electronic , except that the b are not shipped by the b owner to one of Taxpayer's facilities and consigned to Taxpayer. Here, as well, ownership of the b being sold remains with the b owner until the sale.

As a Taxpayer is required by to file a tariff schedule of its selling commissions and other charges. There is a separate tariff schedule for each of Taxpayer's . In addition, Taxpayer's member associations generally charge members a fee for their services, which Taxpayer collects on behalf of the member associations and remits to them. The b owners are responsible for the costs of shipping the b to the facility and for any incidental charges that might be incurred related to their b. Taxpayer subtracts its service charge (determined pursuant to the applicable tariff schedule), the applicable member association fee, any incidental expenses and any applicable promotion program charges from the gross sale proceeds, and pays the balance to the owner.

The b sold, their weight, the price per pound and the gross proceeds are identified. The various deductions described above are itemized. The settlement

statement then shows the net amount due to the owner. The owner receives a check for that amount.

Sales by are treated as consignment sales for federal income tax purposes. As such, they are not reported as purchases and sales by Taxpayer on its federal income tax return. Rather, they are treated as sales by the b owners to the purchaser of the b at the . For sales, Taxpayer is providing a marketing service on a cooperative basis for its member associations and their patrons.

Taxpayer is not currently treating the payments it makes to b owners for b sold at as per-unit retain allocations paid in money and does not propose to do so in the future. Those payments are not the subject of this ruling request.

Approximately percent of the b marketed through Taxpayer are marketed by Agreement. Agreement sales are sales where Taxpayer markets b by purchasing the b and then reselling them, accounting for any net profits realized on the sale on a cooperative basis. In contrast to b sold by , Taxpayer becomes the owner of the b which are sold by Agreement. Taxpayer is at risk if something happens to the b between the time it purchases them and the time they are sold and is responsible for their care and feeding.

Taxpayer reports purchases and sales of b marketed by Agreement as its purchases and sales for financial statement and tax return purposes. To the extent that any such b are on hand at year end, they are reflected in Taxpayer's year-end inventory for financial statement and tax return purposes.

While approximately percent of the b Taxpayer handles are sold at , some b owners prefer to sell their b by Agreement rather than by . The

are designed to result in prices that fairly value b by bringing together a number of potential purchasers who then engage in an open bidding process. However, many b owners are not comfortable with the uncertainty as to price that exists when b are put up for sale by . Owners who sell their b by Agreement know the price they are going to be paid when they enter into an agreement to sell their b.

When Taxpayer purchases b by Agreement for marketing on a cooperative basis, it is customary for the agreement between Taxpayer and the seller to be evidenced by a settlement statement. The settlement statement identifies important elements of the agreement between the parties – the number and kind of b being sold, their weight, the price per pound, the gross sales price, any deductions, and the net amount to be remitted to the seller.

The b that Taxpayer markets by Agreement are purchased from b owners that are all eligible patrons of one of the member associations. These b are, in turn, sold by

Taxpayer to b producers, dealers, or processors either at one of the or by Agreement.

Taxpayer does not charge a service or marketing fee when it markets b by Agreement for an eligible patron of a member association, but most of its member associations charge a fee for such sales. Taxpayer subtracts the member association fee from the check it sends to the patron and remits the fee to the member association. Taxpayer's intention when it markets b by Agreement is to earn a spread that at least covers its costs on such transactions. Any resulting net earnings from such sales enter into the patronage dividends for the year which Taxpayer pays to member associations, which they, in turn, take into account in their determination of patronage dividends to be paid to eligible patrons.

The issue in this ruling is the characterization for purposes of subchapter T of the Code and section 199 of the amounts (referred to in this ruling as "Agreement b payments") that Taxpayer pays to b owners who are eligible patrons of its member associations with respect to b marketed through Taxpayer by Agreement. Because b purchased and resold in this manner are marketed on a cooperative basis, for reasons set forth below, Taxpayer's Agreement b payments should qualify as per-unit retain allocations paid in money. All persons marketing b by Agreement through Taxpayer are patrons of one of the member associations, and because member associations pay patronage dividends to all members (members and nonmembers alike), all are "eligible patrons."

For purposes of this ruling, the term "Agreement b payments" does not include amounts which Taxpayer remits to b owners who choose to market their b through one of the that Taxpayer operates. In addition, the term "Agreement b payments" also does not include patronage dividends paid to member associations of Taxpayer with respect to b marketed for their patrons.

Taxpayer does not operate on a pooling basis. The b owners marketing b through Taxpayer by receive the price determined by the process. The b owners marketing their b through Taxpayer by Agreement receive the price negotiated with Taxpayer. What the negotiated price is depends upon market conditions at the time. That negotiated price is determined without regard to the actual net proceeds that Taxpayer receives for marketing the b it purchases by Agreement. Payments are made in cash (by check) and occur throughout the year as b owners sell b to Taxpayer by Agreement for marketing and are paid pursuant to the terms of their individual agreements with Taxpayer.

After purchasing b by Agreement, Taxpayer then markets the b in the manner that it judges will produce the best return. As described above, any net earnings from marketing the b obtained by Agreement enter into the patronage dividends that Taxpayer pays to its association members (and thus enter into the patronage dividends that association members pay to their eligible patrons).

For its fiscal year ended , Taxpayer's Agreement b payments totaled approximately $ million. Taxpayer has not yet paid its patronage dividends for . It currently anticipates paying a patronage dividend of approximately $ million to its member associations, of which approximately 20 percent will be paid in cash and the remainder will be paid in qualified written notices of allocation (book credits).

Taxpayer historically has treated Agreement b payments made in cash as "purchases" for tax purposes and reported them on Schedule A, Line 2 of its Form 1120-C. Taxpayer has not treated the Agreement b payments made in cash as "per-unit retain allocations paid in money" and, therefore, has not reported them on Schedule A, Line 4b of its Form 1120-C. Taxpayer has reported the patronage dividends paid to member associations as a patronage dividend paid in money and qualified written notices of allocation on Schedule H, lines 3a and 3b of its Form 1120-C.

Taxpayer has valued its b in inventory at year end at lower of cost or market for financial statement and tax purposes, and so a portion of the payments it makes for b purchased by Agreement has entered into its year-end inventory. Taxpayer has not added back Agreement b payments in its section 199 computations for prior years.

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

On receipt of this ruling, Taxpayer plans to change the reporting on its tax return for Agreement b payments, reporting such payments on Line 4b of Schedule A of its Form 1120-C, rather than on line 2. The Agreement b payments will, as in the past, enter into the determination for tax purposes of Taxpayer's cost of goods sold for tax purposes just as they did when reported as "purchases." There will be no impact on Taxpayer's b inventories because Taxpayer will continue to value its b inventories at year end at the lower of cost or market for financial statement and tax purposes and will continue to treat Agreement b payments as a cost for this purpose.

In addition, Taxpayer plans to treat Agreement b payments as per-unit retain allocations paid in money for purposes of computing its section 199 deduction commencing with its fiscal year ended .

Taxpayer does not intend to modify its Articles of Incorporation, Bylaws or any other documents in any manner to change the labels placed upon the Agreement b payments. Taxpayer will make certain that it does not exclude or deduct any Agreement b payments twice on its tax return or add back any Agreement b payments twice in its section 199 computation. Taxpayer may retain all or a portion of its section 199 deduction, or it may pass all or a portion of that deduction through to its patrons.

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 cooperative to which subchapter T applies). It is engaged "in the marketing of agricultural or horticultural products" (i.e., 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. The b owners can market b through Taxpayer in one of two manners – by or by sell the b to Taxpayer by Agreement for marketing by Taxpayer on a cooperative basis. The amount that each b owner receives when he or she sells b to Taxpayer for marketing depends upon which method the member chooses. If the b is marketed by , the owner receives the price less service fees for Taxpayer and the member association and less any related expenses. When Taxpayer purchases b from the b owners by Agreement for marketing on a cooperative basis, the owners receive a negotiated price from Taxpayer reflecting the conditions at the time Taxpayer purchases the b.

The question presented in this ruling is whether the Agreement 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 Agreement b payments in the section 199 computation. If the Agreement 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 Agreement 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 its Agreement b payments as per-unit retain allocations paid in money. However, Taxpayer's Agreement 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 Agreement b payments are made in cash so the "paid in money" requirement is met.

Taxpayer's Agreement 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 Agreement b payments to a member are paid "pursuant to an agreement." That section 1388(f) agreement is reached when the b are purchased and is evidenced by the settlement statement which Taxpayer prepares and gives to the seller of the b along with the payment check. 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 Agreement 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 Agreement b payments as per-unit retain allocations paid in money and not sales.

Second, Taxpayer's Agreement b payments to a b owner are made "with respect to products marketed for him," namely, the b delivered for marketing by Taxpayer. As described above, Taxpayer markets the b it acquires by Agreement and association members share in Taxpayers net earnings from its marketing of each association's patrons' b in the form of patronage dividends. Patrons then share in the earnings of the member associations on a patronage basis.

Third, the amount of the Agreement 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 Agreement 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 Agreement 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 Taxpayer 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 Taxpayer 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 Agreement 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. Taxpayer's Agreement b payments 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 Taxpayer's Agreement b payments.

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: