Internal Revenue Service

Number: **201005015**
Release Date: 2/5/2010

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:5
PLR-123371-09
Date: October 28, 2009

LEGEND:

Taxpayer =

State =

Year S =

Town R =

G% =

H =

I =

J =

K =

L =

M =

N =

O =

P =

Q =

W =

X =

Y =

Z =

Dear

This is in response to a request for a ruling, dated April 30, 2009, and subsequent correspondence, submitted by your authorized representative. The ruling concerns 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, pursuant to section 199(d)(3) of the Internal Revenue Code.

Taxpayer is a nonexempt farmers' marketing and purchasing cooperative organized under the laws of State. Taxpayer has been in operation since Year S. Taxpayer's principal line of business is marketing Q grown in the United States by its members.

Taxpayer also purchases commodities such as W, X, Y, and Z for resale to its members. Taxpayer purchases X at terminals and stores X at its bulk facility located in Town R. Taxpayer also is engaged in the manufacturing and production M, N, O, and P.

Taxpayer's principal line of business is its purchase and resale of I, particularly H, J, K, and L grown by its members. In accordance with its bylaws, Taxpayer enters into marketing agreements with its members. Pursuant to the terms of these agreements, members produce Q and deliver it to Taxpayer at receiving and storage stations located throughout Taxpayer's trade territory in State. Approximately G% of Taxpayer's annual inventory, by volume, is delivered and accepted at harvest time, with the balance of the inventory delivered throughout the remainder of the year. Taxpayer grades its members' Q upon receipt and agrees to receive and store Q, to market Q on its members' behalf, to account for the proceeds of its marketing activities on a non-pooling basis, and to distribute those proceeds to its members.

Taxpayer offers four alternate Q delivery schedules and pricing mechanisms to its members under its written Q contracts:

1. Storage: A member delivers Q and Taxpayer is obliged to store Q in its facility in exchange for a fee. Title does not pass to Taxpayer until the member and Taxpayer agree on a price;
2. Price later: Taxpayer takes delivery of and title to the Q, but agreement on the selling price is deferred until the member selects a spot price, published daily by Taxpayer, on a later date;
3. To arrive: A member and Taxpayer agree on a price for Q to be delivered on a certain date; and
4. Spot price: A member arrives at one of Taxpayer's receiving facilities with Q and sells the Q to Taxpayer at that day's current spot price.

Members select a particular pricing mechanism based on a number of factors, including spot prices, price trends, and cash needs.

After taking delivery of its members' Q, Taxpayer aggregates its inventory for bulk resale by the train load. At the end of the fiscal year, Taxpayer closes its books with respect to business done with each member, at which time it calculates its margin with respect to business done with and on behalf of members.

Members who do business with Taxpayer typically will receive distributions of the net proceeds of Taxpayer's marketing and sales activities in two forms: (1) advances following delivery and acceptance of a member's Q, based on and at the time called for by the pricing mechanism in the parties' written contracts; and (2) patronage dividends calculated on a patronage basis and distributed at the end of each fiscal year, based on Taxpayer's net proceeds from its marketing and sales activities and in accordance with its bylaws.

Advances by Taxpayer to its members are made in the form of checks in accordance with the members' agreements with Taxpayer and State cooperative law. These advance payments assure that Taxpayer remains competitive with non-cooperative Q wholesalers and distributors, which generally pay producers for their Q upon receipt.

Taxpayer does not use "pooling arrangements" or the completed I pool method of accounting. Pooling involves the commingling of commodity products, with each producer paid the average net price received at resale of the pool. Non-pooling cooperatives such as Taxpayer negotiate individually with each producer with respect to the purchase price of the product. In general, non-pooling cooperatives divide the expenses of processing and the revenues from sales among their members. Non-pooling cooperatives resell their members' products in bulk, and each member is allocated a share of the sale proceeds in proportion to the amount of product the member delivered. Each member's margin, however, depends on the price the member agreed in advance to receive from the non-pooling cooperative. As a result, individual

members of non-pooling cooperatives bear the burden and benefits of price fluctuations instead of spreading this risk among all members. Historically, non-pooling cooperatives have labeled advance payments as cost of goods sold and these cost of goods sold are capitalized into the cooperative's inventory.

Taxpayer reports advances paid to producers on Schedule A of Form 1120-C as cost of goods sold. Taxpayer reports amounts distributed to patrons as patronage dividends on Schedule H of such form as a deduction from gross income. For financial accounting and bookkeeping purposes, prior to its current year, Taxpayer denominated such advances as cost of goods sold. For its current fiscal year, in Taxpayer's new accounting software, such advances have been denominated as per-unit retain allocations paid in money.

For tax purposes, Taxpayer does not deduct advances made to members as per-unit retain allocations paid in money. Instead, Taxpayer removes such advances from ending inventory and includes the advances in the cost of goods sold amount for its tax year. Thus, Taxpayer does not double count such advances for purposes of computing its tax liability or making inventory and section 263A computations.

Law and Discussion:

Nonexempt subchapter T cooperatives are permitted to exclude or deduct distributions to their patrons that qualify as patronage dividends or per-unit retain allocations, provided those 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 sections 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 (provided that it does not create or increase a patronage tax loss), 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 provide 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. Taxpayer is an organization to which part I of subchapter T applies. It is engaged in the marketing of agricultural or horticultural products (i.e., Q, which it markets, and various other supplies, which it sells to its members).

As a specified agricultural or horticultural cooperative, Taxpayer is entitled to the benefit of section 199(d)(3)(C) of the Code and section 1.199-6(c) of the regulations which permit such cooperatives to disregard deductions under section 1382(b) and (c) for purposes of computing QPAI and taxable income for section 199 purposes. 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.

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 member’s hands. That is, the member may not count the qualified payment received from the cooperative in the member’s own section 199 computation whether or not the cooperative keeps or passes through the section 199 deduction. Accordingly, the only way that a member 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.

Taxpayer does not operate on a pooling basis. Taxpayer purchases Q from its members markets that Q. The amount that each member receives when the member sells Q to Taxpayer for marketing depends upon which delivery schedules and pricing mechanisms the member chooses. Members have a number of options for determining how and when sales are made. However, all members share in Taxpayer’s net earnings from member Q operations in proportion to the amount of Q they market through Taxpayer. Those net earnings are distributed after the end of each year in the form of patronage dividends.

The question presented in this ruling is whether the cash advances made by Taxpayer to patrons for Q 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 amount of the advances in

the section 199 computation. If the advances to patrons are per-unit retain allocations paid in money, then they should be added back in Taxpayer's section 199 computation and not included in the members' section 199 computations. If the advances to patrons are not per-unit retain allocations paid in money, then they should not be added back in Taxpayer's section 199 computation, but should be included in the 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.

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

First, Taxpayer's advances to a member are paid "pursuant to an agreement," namely the agreement that pre-dates the acquisition of the Q by Taxpayer.

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

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

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

The fact that all patrons do not receive the same payments for their Q (i.e., that Taxpayer does not pool) does not mean that the advances should not be treated as per-unit retain allocations paid in money. In Farm Service Cooperative v. Commissioner, 619 F. 2d 718 (8th Cir. 1980), the Eighth Circuit Court of Appeals characterized payments to Farm Service's poultry growers as per-unit retain allocations paid in money, even though they were determined under a formula that resulted in some poultry growers receiving more than others depending upon the efficiency of their operations and the market price of chickens when they delivered their chickens to Farm

Service. The Tax Court in Farm Service Cooperative v. Commissioner, 70 T.C. 145, 147-148 (1978), described the formula as follows:

> "The grower was paid by petitioner for growing chickens based on the delivery weight to the processing plant, less the weight of chickens condemned by the U.S. Department of Agriculture. The formula under which the grower was paid also took into account variable market rates for full grown chickens, and an efficiency factor that related the number of pounds of feed to the pounds of chickens produced. The efficiency factor was figured into the grower's compensation because Farm Service supplied all chicken feed. Under the contract provisions established with each of the growers, there was also a guaranteed minimum amount the grower would receive from the cooperative irrespective of wholesale market variations. For example, the contract in effect on July 1, 1968, provided that 'In no event will the Grower Member receive less than 1.25 cents per pound less U.S.D.A. condemnation.' On its books, petitioner treated payments to its growers as a cost of production."

Taxpayer's advances qualify as per-unit retain allocations within the meaning of section 1388(f) of the Code because they are: (1) distributed with respect to Q that Taxpayer markets for its patrons; (2) the patrons receive the payments based on the quantity of Q delivered; (3) the advances are determined without reference to Taxpayer's net earnings; (4) the advances are paid pursuant to an agreement with the member establishing the pre-existing agreement and obligation; and (5) the advances are paid within the payment period of section 1382(d). Such per-unit retains are to be reported in box 3 of Form 1099-PATR, "Taxable Distributions Received From Cooperatives."

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 product 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 reasons described above, Taxpayer's cash advances meet the definition of "per-unit retain allocations paid in money." Taxpayer may disregard such payments in determining the amount of its section 199 deduction.

Based on the foregoing, we rule that cash advances from Taxpayer to its members in exchange for Q products grown in the United States are per-unit retain allocations paid in money as defined in sections 1388(f) and 1382(b)(3) of the Code; and that such advances are properly included in QPAI and taxable income of Taxpayer solely for purposes of calculating, at the cooperative level, the deduction allowed under section 199.

No opinion is expressed or implied regarding the application of any other provision in the Code or regulations. The conclusions set forth in this ruling are limited to cash advances made during a year attributable to Q which is sold by Taxpayer during the year. No opinion is expressed or implied as to whether cash advances made during a year attributable to Q which is in inventory at year-end qualify as per-unit retain allocations paid in money.

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

Sincerely yours,

Paul F. Handleman

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