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LEGEND:

Taxpayer =

State A =

Area =

Year 1 =

Year 2 =

b =

c =

Dear

This is in response to a request for rulings dated March 5, 2010, submitted by your authorized representative. The rulings concern the interplay of the rules in subchapter T of the Internal Revenue Code (concerning the taxation of cooperatives and their patrons) and the calculation of the section 199 deduction for certain cooperatives contained in section 199(d)(3).

Taxpayer is organized as a cooperative corporation under the State A Cooperative Act. Taxpayer is a farmers' cooperative whose members are b growers located in Area.

Shortly after it was formed, Taxpayer requested and received a determination letter dated , confirming its status as an "exempt" section 521 farmers' cooperative. Section 1381(a)(1) of the Code provides that part I of subchapter T applies to section 521 cooperatives. Thus, among other things, Taxpayer is entitled to exclude or deduct distributions to its members and other nonmember producers that qualify as per-unit retain allocations or patronage dividends provided the requirements of subchapter T are met.

As a row crop, b is planted each year in the spring. The harvest of b begins in September. At harvest, the members of Taxpayer truck their b to various receiving stations (also referred to as " stations") owned and operated by Taxpayer. Taxpayer currently has strategically located stations. The b are at the receiving stations until they are processed.

Taxpayer then processes the b over a period of approximately to months at processing plants. The principal product is , which is marketed in bulk form and in packaged form under the brand name and over private labels. Processing also results in several marketable by-products, including b which are used for .

In the fall of Year 1, at the beginning of Taxpayer's fiscal year beginning , and ending growers delivered tons of b, grown on acres of land, to Taxpayer for processing. The b delivered in the fall of Year 1 are referred to in this ruling as the "Year 1 crop." The b processing began as the b were delivered, and the processing of the Year 1 crop was completed during . The b were processed into cwts. of c.

Pursuant to the terms of its b agreements with growers, Taxpayer made a series of payments to growers totaling $ for the Year 1 crop. Those payments (and similar payments for each year's b crop) are referred to in this ruling as "b payments." The b payments are made in cash and nonqualified per-unit retain certificates. For the Year 1 crop, $ was paid in cash, and $ was paid in the form of nonqualified per-unit retain certificates.

Taxpayer plans to pay a patronage refund of $ to growers with respect to the Year 1 crop. Of this amount, $ is scheduled to be paid in cash, and $ is scheduled to be paid in qualified written notices of allocation.

Taxpayer is a cooperative corporation organized under the State A Cooperative Act, of the State A Revised Statutes. Entities organized under the State A Cooperative Act as cooperatives are, among other things, required to "[operate] at cost by adjusting the prices charged for goods or services or by returning any net margins at the end of a fiscal year on a patronage basis to members and other persons

qualified to share in the net margins pursuant to the articles and bylaws." Section

The State A Cooperative Act further provides:

> "(2) Net margins, after deductions for reasonable reserves and for allowances for income tax, shall be calculated and allocated on a patronage basis at least once every twelve months to members or to members and other qualified persons on an equitable basis as determined by the board or in accordance with the articles or the bylaws…." Section

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

> "… to receive, handle, manufacture, process, and market the [b] and other agricultural products of its Members and other producers; to purchase, handle, and distribute agricultural supplies and equipment to its Members and other patrons; to perform any and all related services for its Members and other patrons; and to engage in any other lawful purpose. This Cooperative shall be operated on a cooperative basis for the mutual benefit of its Members and patrons." (Article III, Section 1).

Taxpayer is organized with capital stock. Article IV, Section 1. There are two classes of capital stock – Common Stock (with a par value of $1.00 per share) and Patron Preferred Stock (with a par value of $100.00 per share).

The Common Stock is membership stock. Only b producers and cooperative associations of b producers are entitled to be members and own Common Stock. Article IV, Section 2(b). Each person who is admitted to membership is required to pay $100.00 to purchase one share of membership Common Stock. Article IV, Section 2(a). Members are not permitted to own more than one share of Common Stock. Article IV, Section 2(a).

Members are also required to purchase shares of Patron Preferred Stock. Each share of Patron Preferred Stock carries with it the right and obligation to deliver b from one acre of land. Article IV, Section 3. Thus, a member desiring to market b grown on 500 acres of land through Taxpayer each year is required to purchase 500 shares of Patron Preferred Stock.

Dividends are not paid on the Common Stock or the Patron Preferred Stock. Article IV, Sections 2(f) and 3(b). Only the Common Stock has the right to vote, and since each member of Taxpayer owns one share of Common Stock, Taxpayer is organized on a one-member, one-vote basis. Article IV, Section 2(a).

Taxpayer's Articles of Incorporation require that "[a]ll net income (savings) of this Cooperative in excess of reserves established by the Board shall be distributed to Members and patrons on the basis of patronage, as more particularly provided for in the Bylaws." Article V. Taxpayer's Bylaws provide that it "shall be operated on a cooperative basis." Article VII.

Article VIII describes how annual savings are determined and distributed each year as what Taxpayer calls "patronage refunds." The determination begins by determining the "annual income" of Taxpayer, which equals gross receipts less Taxpayer's costs and expenses. For this purpose, included in costs and expenses are b payments made to members and nonmember producers pursuant to the Member and Nonmember Agreements for their b. Also deducted are operating expenses and costs, cost of goods sold, cost of services performed, all taxes and other necessary expenses, reasonable and necessary reserves, bad debts and current obligations on debt and patron preferred stock. Article VIII, Section 2.

The Bylaws then provide that annual income "shall be distributed and paid to members and patrons" as provided in the Bylaws. Article VIII, Section 3. Most (over 88 percent of the Year 2 crop) of the b that Taxpayer processes and markets are grown by members. Taxpayer also processes and markets some b grown by nonmember producers. Taxpayer does business with both members and nonmember producers on a patronage basis and treats members and nonmembers alike with respect to both b payments and patronage dividends.

The Bylaws provide that the distribution of annual income to members and other patrons shall be based on "their patronage" with the cooperative. Article VIII, Section 4. For this purpose, patronage is measured based upon the number of tons of b each member and nonmember delivers. The Bylaws provide that patronage refunds must be paid within eight and one-half months of year end and that they may be made in the form of cash, or written notices of allocation (which may be qualified or nonqualified), or a combination of the two. Article VIII, Section 5. Taxpayer customarily pays its patronage refunds in a combination of cash and qualified written notices of allocation (which it sometimes refers to as "patronage equities").

Members are required to enter into a Shareholder Agreement. Bylaws, Article I, Section 1(e). Under the Articles of Incorporation and the Member Agreement, a member is permitted and obligated to grow one acre of b for each share of Patron Preferred Stock the member owns. Article IV, Section 3(c) of the Articles of Incorporation, and Sections 1 and 20.1 of the Member Agreement. Failure of a member to plant, grow and deliver b in accordance with this requirement may, among other things, result in termination of the member's membership, forfeiture of the member's share of Common Stock and shares of Patron Preferred Stock, termination of the member's Member Agreement and right to deliver b to Taxpayer for processing and/or the imposition of obligation to pay liquidated damages to compensate other members for the member's failure to bear his share of Taxpayer's fixed costs. Section 2.9.

Members owning shares of Patron Preferred Stock in excess of the acres they plan to devote to b production may, with the appropriate approvals from Taxpayer, subcontract their production obligation to a third-party grower. If the third-party grower is not already a member of Taxpayer, the third-party grower must enter into a Non-Member Grower Agreement.

In this ruling the Shareholder Agreement is referred to as the "Member Agreement" and the Non-Member Grower Agreement is referred to as the "Nonmember Agreement." The Member Agreement and the Nonmember Agreement are identical in all material respects. Taxpayer accepts b only from member and nonmember producers and only as provided in the Member and Nonmember Agreements.

Members and nonmembers are required to designate the land on which they will raise b for delivery to Taxpayer each year. Section 1.1 of both Agreements. They agree to deliver all b grown on the designated acreage to Taxpayer. Sections 1.1 and 3.1 of both Agreements. They are not required to deliver, and Taxpayer is not obligated to take b grown on acres in excess of those designated in the Member Agreement. Section 1.1 of both Agreements.

Members and nonmembers agree to grow b on the designated acreage in accordance with growing standards specified by Taxpayer. See Section 2.0 of both Agreements. For instance, they must use approved b seed. Section 2.2 of both Agreements. There are limits on the pesticides and chemicals that may be used. Section 2.5 of both Agreements. Nitrogen fertilizer may not be applied to the crop after July 15. Section 2.4 of both Agreements.

When a member or nonmember delivers b to a receiving station at the time of harvest, the b are weighed. The gross weight of the b is adjusted for dirt, stones, trash and other foreign substances (determined on a sampling basis), and a net weight measured in tons is determined. The b are also tested at the time of delivery to determine their c content. Section 4.3 of both Agreements.

The Member and Nonmember Agreements provide that Taxpayer will pay members and nonmembers for their b an amount determined under a formula set forth in the Agreements. The amount depends upon the "average net selling price for [c]" for the year and the "adjusted [c] content" of the member's or nonmember's b. Section 6.2 of both Agreements. That payment is reduced by what is referred to as "the Shareholder freight participation charge" which is equal to percent of the freight cost incurred by Taxpayer for transportation of a member's or nonmember's b from the receiving station where they are delivered to the contracting factory. Section 6.2 of both Agreements.

The "net selling price for [c]" is defined as "the gross proceeds received by the Cooperative from c sold and delivered during the period of October 1 through September 30 [Taxpayer's fiscal year], less all charges and expenditures of the kind

regularly and customarily deducted from the gross proceeds from such sales." Section 6.6 of both Agreements. Both Agreements then provide:

> "Without limiting the generality of the foregoing, there shall be included among the items deductible from the gross proceeds in determining net selling price for [c] (1) all excise, sales or other taxes of any kind paid or incurred by the Cooperative on, or with respect to, or arising out of the manufacture, processing, production, ownership, possession, holding for sale, sale, marketing or shipment of such [c] or any part thereof, or on all or any part of the selling price from such sale, (2) the profit or loss, if any, resulting from hedging operation conducted by the Cooperative in response to c customers requests for [c] pricing based on [c listed on the , [c] , (3) all costs incurred in preparing [c] for sale including such costs as packaging, and (4) marketing cost including freight, cash discounts, brokerage, loading and handling, advertising and sales, marketing administration and (5) internalized [b] freight." Section 6.6 of both Agreements.

The "adjusted average [c] content" is determined separately for each member and nonmember. That determination is based on the average c content of all deliveries of b by the member or nonmember each crop year. Section 6.4 of both Agreements. The c content is determined based upon the testing, described above, that occurs at the time of delivery.

More is paid for b with a high c content because there is a direct correlation between the c content of a ton of b and the amount of c that can be produced from that ton. Taxpayer offers certain incentives, including a relaxing of the c content standards and an early tonnage delivery premium, to encourage early delivery which allows Taxpayer to more efficiently handle and process the b of all members and nonmembers. Sections 5.0 and Exhibit A of both Agreements.

The Agreements provide that members and nonmembers will receive b payments in installments. Section 8.0 of both Agreements. These installments are referred to as the "initial payment," the "1st interim payment," the "2nd interim payment" and the "final payment." On occasion, Taxpayer also makes what it refers to as "exceptional payments," which are additional installment payments designed to accelerate payments to growers in years when that is deemed appropriate.

- The "initial payment" is an advance made on November 20 (for b delivered through November 5). Section 8.1 of both Agreements. The initial payment is "based on of the Cooperative's then current estimate of the net selling price of [c] for the period October 1 through September 30 to a maximum of $ per pound."

- The “1st interim payment” is an advance made on January 5 each year. This payment “is based on of the Cooperative’s then current estimate of the net selling price of [c] for the period October 1 through September 30 to a maximum of per pound less the initial payment.” Section 8.3 of both Agreements.

- The “2nd interim payment” is an advance made on March 14. This payment “is based on percent of the Cooperative’s then current estimate of the net selling price of c for the period October 1 through September 30 minus the sum of all previous payments and the freight participation defined in paragraph 6.2.” Section 8.4 of both Agreements.

- “Exceptional payments” may be made throughout the year if market conditions allow. They are made to accelerate payments to members and nonmembers when that is deemed appropriate. For example, for the Year 1 crop, Taxpayer made an exceptional payment in February (between its 1st interim payment and its 2nd interim payment) to true-up the actual b payment from $0.2450 per pound to $0.2880 per pound.

- After Taxpayer’s fiscal year closes on September 30, the actual net selling price for c is determined for the year. A “final payment” for a member’s or nonmember’s b is then made, equal to what is due to the grower under the Agreements, less what has previously been paid. Section 8.5 of both Agreements. The final payment is made on October 30. If the sum of the initial and interim payments exceeds the calculated total payment based on actual net selling price, the excess paid will be deducted from the November 20 payment of the following year. If no crop is grown the following year, the grower is obligated to refund the overpayment to Taxpayer. Sections 8.5 of both Agreements.

Taxpayer is authorized by Article IX of its Bylaws to “require investments in its capital in addition to the investments from retained patronage.” These investments take the form of “a retain on a per unit basis as defined by the Board,” and they may be qualified or nonqualified. It has been Taxpayer’s practice to withhold a uniform per-ton retain from the initial payment each year. For the Year 1 crop year, that retain was $ per ton and was evidenced by a nonqualified per-unit retain certificate.

The “final payment” for each crop year required by both Agreements is not based upon Taxpayer’s net proceeds or net earnings for the year. Rather it is based upon the formula contained in the Agreements.

Thus, Taxpayer's "final payment" under both Agreements is not like the final settlement payment made by many pooling cooperatives when a pool closes, which is based upon the cooperative's net earnings for the year and is treated as a patronage dividend for tax purposes. Taxpayer's equivalent to the final settlement payment paid by many pooling cooperatives is the patronage refund (described above) that it pays after the year closes. Taxpayer's patronage refund is based upon its net earnings for the year, treating all b payments as a cost of the b. Thus, notwithstanding the description of the last payment under both of the Agreements as the "final" payment, the "final" payment is not normally the last payment received by members and nonmembers from Taxpayer with respect to each crop year.

In summary, the payments that members and nonmembers receive with respect to each b crop fall in two categories – b payments made pursuant to the Member and Nonmember Agreements and a patronage refund paid pursuant to the Articles of Incorporation and Bylaws. The payments made pursuant to the Member and Nonmember Agreements include the initial payment, the 1st interim payment, the 2nd interim payment, any exceptional payments and the final payment. These are the payments referred to in this ruling as "b payments." The b payments may be made in cash or in per-unit retain certificates, which may be qualified or nonqualified. The focus of this ruling is on whether the b payments made in cash to members and nonmembers are per-unit retain allocations paid in money for federal income tax purposes and, if so, on how they should be treated for purposes of section 199 of the Code.

In the event that Taxpayer incurs a loss in any year, its Bylaws provide that the loss shall first be charged "against the capital reserves, if any." Article XIII, Section 1. The Bylaws provide that if the loss exceeds the capital reserves and results from business done with or for members or patrons, then:

> "…the Board of Directors of the Cooperative shall recover the loss from prior years' annual savings from business done with or for members and patrons by charging the loss against the patronage credit accounts of the members and patrons whose patronage business generated the loss, on the basis of their patronage during the loss year." (Article XIII, Section 2).

Taxpayer has treated b payments to members and nonmembers made each year in cash pursuant to the Member and Nonmember Agreements as "purchases" for tax purposes and reported them on Schedule A, Line 2 of its Form 1120-C. Taxpayer has not reported these b payments as "per-unit retain allocations paid in money" and therefore has not reported them on Schedule A, Line 4b of its Form 1120-C. For tax purposes, Taxpayer accounts for its inventories using the lower of cost or market for both financial statement and tax return purposes. The b payments paid in cash have entered into the determination of the cost of Taxpayer's inventories of c at year end.

Taxpayer has treated patronage refunds paid in cash and written notices of allocation pursuant to its Articles of Incorporation and Bylaws as "patronage dividends"

and therefore has reported them on Schedule H, lines 3a and 3b of its Form 1120-C. Taxpayer did not add back b payments paid in cash to members and nonmembers as part of its section 199 computation in prior years, but it did add back its patronage refunds. In the past, Taxpayer used all of the section 199 deductions it earned on its own tax return, and thus passed none through to members and nonmembers.

Recent developments have caused Taxpayer to reconsider how it should treat its b payments in cash to members and nonmembers for purposes of its section 199 computation. Taxpayer now believes that such payments should be classified as "per-unit retain allocations paid in money." Taxpayer seeks to obtain confirmation of that conclusion.

Taxpayer plans to treat b payments in cash to members and nonmembers as per-unit retain allocations paid in money for purposes of computing its section 199 deduction. Taxpayer does not currently plan to make any change the manner it accounts for inventories for tax purposes. Thus, the timing of the deduction of its b payments will not be changed.

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 that Taxpayer plans to add back in its section 199 computation for a year will equal those deducted on its tax return for the year as costs of goods sold that relate to products marketed during the year. The amount will be computed by adding any b payments in opening inventory for the year together with b payments made during the year, and then subtracting any b payments in closing inventory.

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

B. RULINGS REQUESTED

1. Initial, 1st interim, 2nd interim, exceptional, and final b payments paid in cash to members and nonmembers each year 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 paid in cash to members and nonmembers.

Section 521 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 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 cooperative to which subchapter T applies). It is engaged “in the marketing of agricultural or horticultural products” (i.e., its members and nonmembers b which it processes and markets).

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.

While Taxpayer has never used the terminology customarily used by pooling cooperatives to describe how it operates, it does in fact operate in a manner similar to many pooling cooperatives. Members and nonmembers are entitled to share equally (taking into account quality differences) in what is earned from processing and marketing their b. They receive a series of payments (the b payments) pursuant to the Member and Nonmember Agreements and a final payment (the patronage refund) pursuant to the Articles of Incorporation and Bylaws. The process described earlier in this ruling for determining the amount of the b payments and for determining the patronage refund each year is very much like a traditional pooling process, with the b payments under the Member and Nonmember Agreements functioning like harvest advances and progress payments and the patronage refund functioning like the final settlement payment after the pool closes.

The question presented in this ruling is whether the b payments made by Taxpayer to patrons 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 and nonmembers are per-unit retain allocations paid in money, then they should be added-back in Taxpayer's section 199 computation and not included in the members' and nonmembers' section 199 computations. If the b payments to members and nonmembers are not per-unit retain allocations paid in money, then they should not be added-back in Taxpayer's section 199 computation, but should be included in the members' and nonmembers' 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.

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."

Taxpayer's b payments paid in cash to members and nonmembers meet the definition of "per-unit retain allocations paid in money," which are excludible or deductible under section 1382(b)(3) of the Code. In the case of b payments made in the form of nonqualified per-unit retain certificates, the payments are not currently deductible, but when the certificates are some day redeemed Taxpayer may be entitled to a deduction under section 1382(b)(4).

Taxpayer's b payments are paid to members and nonmembers "pursuant to an agreement," namely the Member and Nonmember Agreements described above. They are made "with respect to products marketed for [patrons]," namely, c processed from the b of Taxpayer's members and nonmembers. The b payments are "fixed without reference to the net earnings" of Taxpayer. They are paid pursuant to a formula which takes into account the adjusted average c content of each member's and nonmember's b and the net selling price of c for the year. This formula is not based on either the net proceeds or net earnings of Taxpayer. This is true not only for the initial, 1st and 2nd interim and any exceptional payments, but also for the payment described by Taxpayer as the "final" payment.

The payment that Taxpayer makes to members and nonmembers each year that is determined by reference to its net earnings is its patronage refund. Taxpayer's patronage refunds meet the definition of a patronage dividend.

Taxpayer's patronage refund each year is made pursuant to "an obligation of such organization to pay such amount," which is set forth in the Articles of Incorporation and Bylaws. In contrast to the b payments, the patronage refund is determined by reference to the net earnings of Taxpayer for the year. The patronage refund is distributed on a patronage basis. Thus, all of the requirements of the definition of "patronage dividend" are met.

In summary, Taxpayer's b payments meet all the requirements specified in subchapter T of the Code for "per-unit retain allocations." The portion paid by check qualifies as a "per-unit retain allocation paid in money." The portion paid in the form of unit retains evidenced by certificates qualifies as a "per-unit retain allocation paid in certificates." Taxpayer's patronage refunds paid each year in the form of cash and written notices of allocation meet the requirements of a "patronage dividend."

Historically, Taxpayer has not reported its b payments in cash in the manner that many pooling cooperatives report pool distributions. Taxpayer has treated such payments as "purchases," not as "per-unit retain allocations paid in money and certificates." However, how the payments have been reported should not obscure what the payments really are.

Section 199(d)(3)(C) of the Code provides that the section 199 deduction of agricultural cooperatives is to be "computed without regard to any deduction allowable under section 1382 (b) or (c) (relating to patronage dividends, per-unit retain allocations and nonpatronage distributions)." Section 1.199-6(c) of the regulations provides that this rule applies for purposes of computing both qualified production activities income and taxable income.

The fact that all members and nonmembers do not receive the same payments for their b 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 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 and nonmember patrons meet the definition of "per-unit retain allocations paid in money." The per-unit retains must be treated as such for all purposes of the Code and are reported in box 3 of Form 1099-PATR, "Taxable Distributions Received From Cooperatives." If properly treated as per-unit retain allocations paid in money, then Taxpayer will be entitled to disregard such payments in determining the amount of its section 199 deduction.

Accordingly, we rule as requested that:

1 Initial, 1st interim, 2nd interim, exceptional, and final b payments paid in cash to members and nonmembers each year 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 paid in cash to members and nonmembers.

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

This ruling is directed only to the taxpayer that requested it. Under section

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

Sincerely yours,

Paul F. Handleman

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