Internal Revenue Service

Number: **201250009**
Release Date: 12/14/2012

Index Number: 1382.00-00, 199.06-00

Department of the Treasury
Washington, DC 20224

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

Refer Reply To:
CC:PSI:B05
PLR-112454-12
Date:
September 11, 2012

LEGEND:

Taxpayer =

State A =

Company A =

Company B =

Bank =

Dear

This is in response to a request for rulings dated March 20, 2012, submitted by your authorized representative. The rulings concern the interplay of the rules in subchapter T of the Internal Revenue Code (concerning the taxation of cooperatives and their patrons) and the calculation of the section 199 deduction for certain cooperatives contained in section 199(d)(3).

Taxpayer is organized as a cooperative corporation under the laws of State A Cooperative Marketing Act. The Act provides that "[a]ssociations organized under this act shall be deemed nonprofit, as they are not organized to make profit for themselves, as such, or for their members as such, but only for their members as producers."

Taxpayer is a full-service farmers cooperative offering a complete line of supplies and services for approximately producer members and participating patrons in counties throughout central State A.

The principal products and services that Taxpayer provides to its members and participating patrons are as follows:

- Grain marketing**.** Taxpayer's members and participating patrons grow wheat, grain sorghum (milo), corn and soybeans. Through a combination of its own efforts and those of a joint venture with other cooperatives known as Company A, Taxpayer makes it possible for its members' and participating patrons' grain to be marketed on a cooperative basis. Company A's grain sales for its fiscal year ended totaled $, and Taxpayer's members and participating patrons accounted for a significant portion of that grain.

- Agronomy products and services**.** Taxpayer supplies its members with fertilizer, crop protection products and seed. Taxpayer has fertilizer facilities at locations throughout its trade territory. Taxpayer also provides members with various agronomy services, such as seed cleaning and custom application of agronomy products. Taxpayer maintains a complete line of rental equipment to meet its members' agronomy product application needs.

- Fuel. Taxpayer supplies members with diesel fuel, heating oil and gasoline. Taxpayer offers 24-hour fuel service at locations and delivers bulk fuel to its members on their farms.

- Feed. Many of Taxpayer's members are involved in livestock (swine, beef and dairy) and poultry production. Through a joint venture with other cooperatives known as Company B, Taxpayer makes feed available to these members.

Taxpayer is organized and operated on a cooperative basis and qualifies as a nonexempt subchapter T cooperative. Taxpayer limits its membership to persons who are bona fide producers of agricultural products. Each member is required to purchase one share of common stock when he or she first becomes a member, and to earn an additional shares of common stock as part of his or her patronage dividends from Taxpayer. Common stock is the only voting stock of Taxpayer. Taxpayer's Articles of Incorporation provide that "[e]ach eligible holder of common stock shall be entitled to only one vote in any meeting of the stockholders, regardless of the number of shares of stock owned." Thus, voting is on a one-member, one-vote basis. Because common stock may only be owned by producers, producers collectively control Taxpayer.

Persons who are not producers may become "participating patrons." Participating patrons are eligible to share in patronage dividends, but they are not permitted to vote. When they become participating patrons, they are required to purchase one share of "participating stock," which is similar to the common stock except that it does not have voting rights. They are also required to earn an additional shares of participating stock as part of their patronage dividends.

As a cooperative, Taxpayer operates at cost. Taxpayer is obligated by its Articles of Incorporation and Bylaws to allocate and pay patronage dividends to its members and participating patrons each year out of its net earnings from business done with or for members and participating patrons. Most (over percent) of Taxpayer's business is conducted with or for members and participating patrons on a patronage basis. For patronage purposes, Taxpayer accounts for its business based using four allocation units:

- Grain. Patronage income from Taxpayer's grain business (including the patronage portion of put through fees Taxpayer receives from Company A, its distributive share of Company A income or loss, and its storage and drying income) is shared by members and participating patrons delivering grain to Taxpayer's elevators for sale to Company A based upon bushels of grain. The grain business is described in detail below.

- Agronomy. Patronage income from sales of agronomy products and services is shared by members and participating patrons based upon dollars of purchases of agronomy products and services from Taxpayer.

- Energy. Patronage income from sales of energy products is shared by members and participating patrons based upon dollars of purchases of energy products from Taxpayer.

- Other supplies and feed**.** Patronage income from sales of other supplies and from Taxpayer's distributive share of Company B's income is shared by members and participating patrons based upon dollars of purchases of other supplies from Taxpayer and feed from Company B.

Taxpayer pays its patronage dividends in cash and qualified written notices of allocation (referred to by Taxpayer as revolving fund certificates), which provide a significant source of working capital for Taxpayer.

For its fiscal year ended , Taxpayer's patronage dividends totaled approximately $ million (of which, approximately $ million was paid by the grain allocation unit). Patronage dividends were paid percent in cash and percent in qualified written notices of allocation.

Taxpayer and its predecessors have been in the grain marketing business for many years. In , Taxpayer and other cooperatives formed Company A in an effort to market the grain of their members more effectively.

Company A is organized as a State A limited liability company (taxed as a partnership for federal income tax purposes). Its members are Taxpayer,

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Taxpayer is the principal member of Company A – currently Taxpayer is entitled to share in percent of Company A's profits and losses and has percent of the votes.

Company A was organized to allow Taxpayer and the other cooperative members to market the grain of their farmer members more effectively on a cooperative basis. With the formation of Company A, the grain marketing activities previously conducted exclusively by each of the cooperatives were divided between Company A and the cooperatives in a manner intended to allow the cooperatives and Company A to market the grain of the members of the cooperatives more efficiently and effectively.

Several principles governed the division of responsibilities. Generally, activities that could be more effectively conducted jointly were assigned to Company A, and those that could be more effectively conducted separately were retained by the cooperatives. While a number of responsibilities have been transferred to Company A, the cooperatives remain actively involved in the grain marketing process.

Currently, the division of responsibilities between Company A and its cooperative members is as follow:

First, each cooperative continues to own the grain elevators it historically owned (or subsequently constructed or acquired after the formation of Company A) and continues to have any related debt. The cooperatives are each responsible for the costs of operating and maintaining their own elevators. Thus, they are responsible for such costs as utilities, insurance, repairs and maintenance, and property taxes related to the elevators. The Warehouse Agreement specifies that each cooperative is responsible for maintaining its elevators "in good operating condition at all times." It also provides that each cooperative is responsible for insuring the elevators and for any environmental liabilities related to operation of the elevators.

Currently Taxpayer owns grain elevators that are part of the Company A joint venture at locations, and these elevators have a combined storage capacity of million bushels of grain. One of the other cooperatives in the joint venture owns grain elevators, and the other own each.

Second, Company A currently has the responsibility of purchasing grain from the farmer members of the cooperatives, setting the bid prices and discount schedules for each elevator, entering into grain purchase contracts with the farmer members, preparing grain settlement statements and paying members for the grain when each purchase is consummated, owning and financing the grain inventories, hedging the inventories and open grain purchase and sale contracts, selling the grain to customers and arranging the logistics for shipping the grain to customers.

Company A has a $ million seasonal line of credit with Bank, to permit it to finance its grain purchases, grain inventories and hedging activities. Originally, Bank required the members of Company A to guarantee Company A's borrowing. Over the years Company A has built up its equity by retaining a portion of its earnings. As a result, Bank no longer required a member guarantee – the members' equity in Company A effectively replaced the members' guarantee. While Company A is the borrower, the relationship with Bank is jointly managed by Taxpayer's Chief Executive Officer, Taxpayer's Chief Financial Officer and Company A's Chief Operating Officer.

The activities described above were centralized at Company A because they are the activities that the members of Company A felt would result in cost savings and revenue enhancement if conducted jointly.

Third, to allow Company A to conduct the activities described above, the members of Company A and Company A have entered into the Warehouse Agreement, which grants Company A "the exclusive right and license to manage and operate the [members elevators] as grain warehouse(s) duly licensed in [State A] under [Company A]'s grain warehouseman's license under the [State A] Warehouse Act." Warehouse Agreement, Section 1.

Fourth, while Company A is responsible for managing and operating the elevators, it does not have the employees and back-office capabilities to permit it to do so itself. Thus, it has outsourced these functions to its members through the Warehouse Agreement. Company A focuses on the marketing of the grain. The day-to-day operations at each member cooperative's elevators continue to be conducted by the cooperative and its employees under the general over-all direction of Company A.

As a result:

- Each cooperative is responsible for receiving and weighing the grain delivered to its elevators, for testing the grain and for assessing appropriate dockage for the grain.

- Each cooperative and the Company A fieldmen are involved in preparing appropriate grain contracts, and each cooperative handles the other paperwork associated with the receipt and purchase of grain, including elevator tickets, warehouse receipts (for grain stored for members), and settlement statements and grain checks (for grain purchased from members). All of this is done in Company A's name and the checks are drawn on Company A's bank account.

- Each cooperative is responsible for the costs of drying wet grain delivered to its facilities.

- Each cooperative is responsible for monitoring the grain in its elevators, maintaining that grain in condition, and has agreed to indemnify Company A "for any deterioration, or failure of grain quality…" This includes monitoring grain which is owned by Company A and grain which is in storage for others.

- Each cooperative is responsible for loading out the grain from its elevators for shipment in accordance with Company A's instructions.

- Annually a review is made of the quantity and quality of all grain on hand and shipped from the elevators of each cooperative and compared to the dockage assessed to the grain as delivered to the elevators. The cooperative is responsible to "reimburse [Company A] for the additional dockage incurred by [Company A] on the grain…" Similar adjustments are made for deficiencies in quantities of grain. This places the risk of loss with respect to the quantity and quality of the grain in the elevators upon each of the cooperatives, much as if the cooperative was the owner of the grain.

The Operating Agreement and Warehouse Agreement together provide how the net earnings of the joint venture are shared by the members of Company A. The Warehouse Agreement provides that each cooperative will be paid a "'put through fee' for each bushel delivered and accepted on a dry clean basis" at the cooperative's elevators. The put through fee is currently per bushel for corn and per bushel for all other grains. The put through fee is intended to compensate each cooperative for use of its elevators and for the services provided by the cooperatives operating the elevators. In addition, since each cooperative has the responsibility for drying grain, "[a]s compensation, the Cooperative shall be entitled to retain the benefit of all moisture discounts for such grain," i.e., drying fees.

Finally, the Warehouse Agreement provides that each cooperative member of Company A shares in the storage income earned at all elevators based upon the ratio of the number of bushels of licensed and approved storage capacity of each member's elevators to the licensed and approved storage capacity of all members' elevators. The Warehouse Agreement describes the rationale for this sharing as follows:

> "[Company A] and its Members recognize that it will be in the best interest of the parties if the marketing, handling and storage decisions for grain are made by [Company A] but with the combined operations in mind. Such decisions will mean some Facilities are used more for storage than others, but the storage benefit should be shared among all Members of [Company A]"

Because all storage activities are performed by the members and the grain is stored in elevators owned and maintained by the members, the storage income is treated as earned directly by the members for accounting and tax purposes.

The Operating Agreement provides that the net earnings of Company A (after subtracting the put through fees exclusive of any storage income) will be shared by members "in accordance with their Percentage Interests." The percentage interests of the members of Company A currently are as follows: Taxpayer (percent), (percent), (percent), and the (percent). These percentages are determined based upon "the total licensed storage capacity of any one Member as the numerator to the total licensed capacity of all [Company A] Members as the denominator…" This is the same formula used to share the storage income. Currently the licensed storage capacity of Taxpayer's elevators is bushels, and the licensed storage capacity of all members' elevators is bushels, so Taxpayer's percentage interest is percent. The percentage interests are adjusted from time to time to reflect changes to the storage capacity of existing elevators and the acquisition by members of additional elevators.

Company A's earnings are shared based upon relative licensed storage capacity for several reasons. Company A and its members recognize that the earnings of a grain elevator are generally directly related to the storage capacity of the elevator. Thus, if two grain elevators each handle 1 million bushels of grain during the year and one has significantly less storage capacity than the other, the one with less storage capacity is generally going to be less profitable because it will be unable to generate profits that are associated with carrying grain. Company A's profit sharing is designed to reflect the profitability of what each member brings to the venture, measured in terms of the storage capacity of the members' elevators. Company A and the members as a group have also wanted to incent the addition of storage capacity, and the sharing ratio does that.

Company A does not distribute all of its earnings to members each year in cash (though, since Company A is taxed as a partnership, each member is taxed on its distributive share of earnings whether or not distributed). Over the years, Company A has retained a portion of the earnings to build up its working capital.

For financial reporting purposes, Taxpayer is required to prepare its financial statements on a consolidated basis including Company A and other controlled subsidiaries and reflecting the noncontrolling interest of the other members of Company A as a separate component (which is negative) of consolidated members' equity. As noted above, currently Taxpayer's percentage interest in Company A is percent. This percentage interest is used not only for sharing profits and losses, but also for voting purposes. The Operating Agreement provides that "each Member of this Company shall have a vote equal to such Member's Percentage Interest in this

Company…" However, Taxpayer's percent percentage interest does not give Taxpayer unfettered control of Company A since decisions "not in the ordinary course of business" require approval of a Super Majority Interest (defined as two or more members owning more than percent of the percentage interests). However, as the predominant member, Taxpayer has significant influence and control of Company A.

The grain purchases and sales are currently reported on Taxpayer's consolidated financial statements as Taxpayer's consolidated purchases and sales. However, for tax return purposes, Taxpayer and Company A file separate returns.

Company A files a partnership return on Form 1065, reporting grain purchases and sales and its net income (after subtracting put through fees and other expenses of operation). Taxpayer files a federal income tax return on Form 1120-C. Besides reporting the income and expenses of its supply business, that return reports its put through fees, drying and storage income, Taxpayer's distributive share of Company A income or loss, and expenses related to maintaining and operating the grain elevators. The return does not report grain purchases and sales or the grain inventories, since those are reported on the Company A return.

For patronage purposes, Taxpayer treats its grain activities as a separate allocation unit. Taxpayer has detailed information of the grain purchased from members, participating patrons and others at its grain elevators. Taxpayer determines its net earnings from its grain marketing activities (including in that determination put through fees, drying and storage income and its distributive share of the earnings or loss of Company A), retains the portion attributable to nonmember patrons (and pays tax on that portion), and allocates the remainder among members and participating patrons on a patronage basis based upon bushels of grain purchased at Taxpayer's elevators, distributing that amount as a patronage dividend. Those patronage dividends are excluded or deducted on Taxpayer's tax return.

As a partnership, Company A does not itself figure a section 199 deduction and pass that deduction through to its members. Company A treats its grain activities as giving rise to domestic production gross receipts and its wages as attributable to domestic production gross receipts. In determining its ordinary income and domestic production gross receipts it has not added back any of the grain payments it makes to the farmer members and participating patrons of its cooperative members.

Company A, Taxpayer and the other cooperative members of Company A are proposing to change the manner in which some of the grain that is marketed through Company A will be purchased.

As described in detail above, Taxpayer owns and operates (under Company A's direction) grain elevators. Taxpayer is responsible for staffing and operating each of its grain elevators. It is also responsible for:

- receiving, weighing and testing the grain delivered to its elevators,
- if the grain delivered is wet, assessing the proper moisture discount and drying the grain,
- maintaining the grain in condition while stored in the elevators (either for the account of farmers or for Company A),
- loading the grain out of the elevators pursuant to Company A's direction.

Taxpayer currently is liable to Company A if (i) there are errors in weighing the grain delivered to its elevators, (ii) any of the grain it accepts at the elevator is contaminated or has any other quality problems that are not identified when the grain is tested and graded at the time of delivery, (iii) the condition of the grain deteriorates while in Taxpayer's elevators, or (iv) the grain is damaged while in the elevators as a result of a fire, explosion or other similar event, or (v) there are errors in loading the grain out of the elevators.

The other cooperative participants in the Company A venture have similar responsibilities under the Warehouse Agreement with respect to grain at the elevators each owns and operates. No change is contemplated in these elements of the division of responsibilities between Company A and the cooperative members, who will continue to own and operate (under the direction of Company A pursuant to the Warehouse Agreement) their respective elevators and to be responsible for the grain as described above.

Some of the grain that is delivered by farmers to the elevators of Taxpayer and the other three cooperatives is purchased by Company A pursuant to forward contracts, deferred pricing contracts, and other kinds of special contracts entered into between the farmers and Company A that call for the purchase of grain other than for the current cash bid prices. It is currently contemplated that the treatment of these contract purchases will not change. The specialists who enter into these contracts with farmers on behalf of Company A are and will remain employees of Company A, and they will remain responsible for contracting with farmers for this grain. Company A will continue to be the purchaser of this grain, and Company A will continue to pay the farmers pursuant to the contracts.

However, much of the grain that Company A markets is delivered by farmer members initially for open storage and is later purchased by Company A at the current cash bid price. Such purchases are commonly referred to as "cash grain purchases." Employees of the cooperative members of Company A are instrumental in consummating these purchases and handling the paperwork for them on Company A's behalf, and the cooperative members effectively guarantee the quantity and quality of the grain being purchased. However, the purchaser of record for this grain is Company A.

The treatment of cash grain purchases will change. Taxpayer will become the purchaser of grain purchased on that basis at the elevators Taxpayer owns and operates. The other three cooperatives will similarly become the buyers of grain purchased on this basis.

Taxpayer intends to enter into Master Marketing Agreements with farmers delivering grain to its elevators for open storage. The Master Marketing Agreements will provide the framework for later cash grain purchases by Taxpayer. They will contain terms customary to grain purchase agreements. They will provide that title and risk of loss with respect to the grain purchased pursuant to the agreements will pass from the farmers to Taxpayer at the time agreement is reached as to the price per bushel of the grain. In situations where Taxpayer does not have a Master Marketing Agreement in place with a farmer interested in selling grain to Taxpayer on a cash basis, Taxpayer and the farmer will enter into a Sale/Purchase Contract to document the purchase.

As the purchaser of the grain, Taxpayer will be responsible for paying farmers the agreed purchase price. Taxpayer will pay farmers for the grain by a check or ACH deposit drawn on a Taxpayer bank account. The check will be accompanied and the ACH deposit will be followed by a grain settlement statement, specifying Taxpayer as the purchaser and the farmer as seller of the grain, itemizing the kind, weight and quality of the grain being purchased, the price per bushel of the grain, storage charges, applicable discounts, taxes and the net amount due the farmer. The grain check or ACH deposit receipt sent to farmer members of Taxpayer (and to other persons entitled to share in patronage dividends) will contain a notice that the payment constitutes a per-unit retain allocation paid in money.

The amounts that Taxpayer will be obligated to pay to members and participating patrons for grain purchased pursuant to Master Marketing Agreements and Sale/Purchase Contracts are what are referred to as “grain payments” in this ruling. For purposes of this ruling, the term “grain payments” does not include patronage dividends paid to members and participating patrons with respect to their grain. It does not include any grain payments that Company A will make to patrons pursuant to special contracts described above or any amounts paid for grain by Taxpayer or Company A to nonmember patrons not entitled to share in patronage dividends.

Taxpayer will, in turn, simultaneously sell the grain it purchases to Company A for marketing by Company A along with the grain Company A will continue to buy directly from farmers and with grain Company A purchases from the other members of Company A, with title and risk of loss passing from Taxpayer to Company A. The other cooperatives will do likewise with respect to the grain they each purchase. The Warehouse Agreement will be amended to set forth the terms and conditions of the sales of grain from Taxpayer and the other cooperatives to Company A. The terms and conditions will be those customary in grain contracts.

The amended Warehouse Agreement will provide that Company A will purchase the grain from Taxpayer (and each of the other three cooperatives) at for the price per bushel paid by them (net of any discounts other than moisture discounts) to the farmers for the grain, plus a mark-up to be determined from time to time. Company A will remain obligated to pay Taxpayer and the cooperatives the put through fees currently provided for in the Warehouse Agreement with respect to the grain. Also, as members of Company A, Taxpayer and the other cooperatives will continue to share in the profits that Company A earns from its grain marketing and storage activities as described above.

After the changes described above, Taxpayer will reflect the purchases and sales of the grain it buys from farmers pursuant to the Master Marketing Agreement and Sale/Purchase Contracts in its financial statements and on its tax returns. Taxpayer will continue to treat its grain marketing activities as a single allocation unit for patronage dividend purposes. It will not conduct its grain marketing activities on a pooling basis. Taxpayer will treat grain payments to farmers who are members or participating patrons as per-unit retain allocations paid in money. More important, Taxpayer will report the grain payments in box 3 of Form 1099-PATRs provided to its members and participating patrons.

Taxpayer requests confirmation that its grain payments to members and participating patrons will qualify as per-unit retain allocations paid in money and that Taxpayer will be entitled to add those amounts back in its section 199 computation. Taxpayer will make certain that it does not exclude or deduct any grain payments to members and participating patrons twice on its tax return or add back any such 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.

Based on the foregoing, Taxpayer requests the following rulings:

1. Taxpayer's grain payments to members and participating patrons will constitute "per-unit retain allocations paid in money" within the meaning of section 1382(b)(3) of the Code.

2. By virtue of section 199(d)(3)(D) of the Code, Taxpayer will be treated as having manufactured, produced, grown or extracted in whole or significant part the grain it purchases from members and participating patrons pursuant to the Master Marketing Agreements and Sale/Purchase Contracts, which the members and participating patrons have so manufactured, produced, grown or extracted.

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

any deduction for Taxpayer's grain payments to members and participating 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., grain).

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. After the changes described above, members and participating patrons will be able to market grain through Taxpayer and Company A in one of two manners: (i) by selling the grain directly to Taxpayer by forward contracts, deferred pricing contracts, deferred payment contracts or other kinds of special contracts entered into between patrons and Taxpayer, or (ii) by selling the grain to Taxpayer pursuant to the Master Marketing Agreement or a Sale/Purchase Contract. Grain that Taxpayer purchases will, in turn, be sold to Company A for marketing.

The question presented in this ruling is whether the grain payments to be made by Taxpayer for grain purchased through the Master Marketing Agreement and Purchase/ Sale Contracts will 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 grain payments in the section 199 computation. If the grain payments 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 patrons' section 199 computations. If the grain payments 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 patrons' 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.

For reasons set forth below, Taxpayer's payments for grain purchased pursuant to the Master Marketing Agreement or Sale/Purchase Contracts meet the definition of "per-unit retain allocations paid in money" which are excludible or deductible under section 1382(b)(3) of the Code.

Taxpayer's grain 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 participating 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 grain payments to a member or a participating patron are paid "pursuant to an agreement," namely the Master Marketing Agreement or Sale/Purchase Contract. The agreement required in section 1388(f) of the Code is an agreement between Taxpayer and the member or participating patron that the amount is a per-unit retain allocation and does not represent proceeds from a sale to the cooperative. Providing a notice to the member or the participating patron that grain payments constitute per-unit retain allocations paid in money and reporting grain payments as per-unit retain allocations paid in money in box 3 of Form 1099-PATR demonstrate that Taxpayer and the member or the participating patron agreed to treat grain payments as per-unit retain allocations paid in money and not sales.

Second, Taxpayer's grain payments to a member or participating patron are made "with respect to products marketed for him," namely, the grain purchased from him or her by Taxpayer pursuant to the Master Marketing Agreement or Sale/Purchase Contract. As described above, Taxpayer will market the grain it purchases from members and participating patrons by reselling that grain to Company A for marketing. Taxpayer currently accounts for its own grain marketing earnings and distributive share of grain marketing earnings of Company A on a patronage basis, paying patronage dividends to members and participating patrons delivering grain marketed through Company A and will continue to do so.

Third, the amount of the grain payments to each member and participating patron "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 and participating patrons do not receive the same payments for their grain (i.e., that Taxpayer does not pool) does not mean that grain 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 Taxpayer's grain payments will meet the definition of "per-unit retain allocations paid in money" in any event. Nothing in subchapter T of the Code limits the exclusion or deduction for per-unit retain allocations to cooperatives with pools.

Section 1.199-6(k) of the regulations provides that section 1.199-6 is the exclusive method for the cooperative and its patrons to compute the amount of the section 199 deduction.

The effect of these sections is that a cooperative such as Taxpayer will compute the entire section 199 deduction at the cooperative level and that none of the distributions whether patronage dividends or per-unit retain allocations received from the cooperative will be eligible for section 199 in the patron's hands. That is, the patron may not count the qualified payment received from the cooperative in the patron's own section 199 computation whether or not the cooperative keeps or passes through the section 199 deduction. Accordingly, the only way that a patron can claim a section 199 deduction for a qualified payment received from a cooperative is for the cooperative to pass-through the section 199 amount in accordance with the provisions of section 199(d)(3) of the Code and the regulations thereunder.

We note that to prevent a cooperative from deducting the per-unit retain allocations made in money or qualified certificates for the second time when the associated grain 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 grain payments to members and participating 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. 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. Furthermore, because Taxpayer is treated as marketing grain by reselling the grain to Company A for marketing, Taxpayer is treated as having grown in whole or significant part any grain marketed by Taxpayer that its patrons grew.

Accordingly, we rule as requested that:

1. Taxpayer's grain payments to members and participating patrons will constitute "per-unit retain allocations paid in money" within the meaning of section 1382(b)(3) of the Code.

2. By virtue of section 199(d)(3)(D) of the Code, Taxpayer will be treated as having manufactured, produced, grown or extracted in whole or significant part the grain it purchases from members and participating patrons pursuant to the Master Marketing Agreements and Sale/Purchase Contracts, which the members and participating patrons have so manufactured, produced, grown or extracted.

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

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: