Internal Revenue Service

Number: **200838011**
Release Date: 9/19/2008

Index Number: 1382.00-00, 199.06-00

Department of the Treasury
Washington, DC 20224

[Third Party Communication:
Date of Communication: Month DD, YYYY]

Person To Contact:
, ID No.

Telephone Number:

Refer Reply To:
CC:PSI:B05
PLR-107037-08
Date:
June 18, 2008

LEGEND:

Coop =

Sub =

State A =

States =

b =

c =

Dear :

This is in response to a request for ruling dated February 13, 2008, submitted by your authorized representative. The ruling concerns the interplay of the rules in subchapter T of the Internal Revenue Code (concerning the taxation of cooperatives and their patrons) and the calculation of the section 199 deduction for certain cooperatives contained in section 199(d)(3).

Coop is a nonexempt agricultural cooperative corporation organized and existing under the laws of the State A. Sub is a wholly owned subsidiary of Coop and is also a nonexempt agricultural cooperative corporation organized and existing under the laws of the State A. Coop and Sub operate under a Marketing Agreement to process and market b products for the b farmer members of Coop. The members of Coop are b farmers in States who deliver their c to Coop. Coop transfers the product to Sub under the Marketing Agreement. Sub processes the c into a variety of products and then markets those products. Coop and Sub have a March 31 year end. At the end of each year, Sub computes its net proceeds and distributes the patronage income to its parent, Coop, for distribution to its members.

The Coop's and Sub's Marketing Agreements clearly state that the cooperatives must distribute the net proceeds on a patronage basis, but like many other c cooperatives around the country, Coop and Sub have capitalized a portion of the net proceeds, known as the "c Check," into inventory.

The Marketing Agreement states in Section G that all member b products received by the cooperative may be mingled with other members' products and pooled. The duration of the pools will be Coop's fiscal year unless Coop chooses another period. Coop has consistently used an annual pool beginning on April 1 and ending on March 31. The Marketing Agreement in Section I defines the "net proceeds" of the cooperative as "the proceeds remaining from sale of b products, after deducting all costs, expenses and charges." None of the payments to the members are included in the "net proceeds" computation. Section J of the Marketing Agreement sets the "pre-existing legal obligation" of the cooperative to pay the members their proportionate share of the "net proceeds" based on their deliveries of c.

Coop makes payments to its patrons each year pursuant to the Marketing Agreement, the terms of which provide, in substance, that it pays the patrons its patronage source net proceeds computed on a book basis. Because c is delivered daily throughout the year, the Marketing Agreement provides that the member receives one or more advances following delivery and acceptance of the member's c. Coop has historically made payments to the members on or about the 20th and 30th of each month for these advances. These payments are also known as the "c Check". Coop references several pricing mechanisms to determine the c Check. This advance amount keeps the cooperative competitive with non-cooperative c processors. But as the Marketing Agreement clearly states, this amount is merely an advance on the ultimate net proceeds due to the member under the Agreement.

At the end of the year, Coop distributes the remaining amount of net proceeds to the patrons. As will be discussed below, for federal tax purposes, the advance payments, or c Checks, are considered advances on the net proceeds and treated as "per-unit retains paid in money." The final payment is made after the audited financial statements are approved by the Board of Directors for the remaining amount of the actual Net Proceeds for the c marketed during the underlying fiscal year. The final payment is considered a "patronage dividend" for federal income tax purposes, and there is a requirement that at least 20 percent of the patronage dividend be paid in cash and the remainder in qualified written notices of allocation for the full amount to be deductible by the Coop and includible in the income of the patrons.

As described in the Marketing Agreement, Coop operates, as many marketing cooperatives around the country do, as a pooling cooperative. In general, a pooling cooperative is a marketing cooperative that segregates the patronage product received during the year into a pool. A pool opens as deliveries of a product are made, and closes after all, or substantially all, of the product is sold or disposed of. In some cases, a cooperative will leave the pool open into the next year, called the “open pool” method. In other cases where sufficient information is available, the cooperative will close the pool at its year end and sell the remaining patronage product in inventory forward to the next year’s pool at the product’s value determined at lower of cost or market, called the “closed pool” method. The cooperative distributes the net proceeds from the sale of each pool to the patrons generally in proportion to the volume of the commodity delivered to the pool. Pooling is essentially a risk sharing device. Rather than each patron separately selling his or her product for a market price at the time of delivery, all patrons co-mingle their product and share the revenues and expenses of processing and selling. In effect, each producer receives an average price.

Coop’s pooling arrangement is such that a separate pool is opened with each fiscal year. Coop is using the “closed pool” method in its financial statement and tax return accounting. Coop has always capitalized into inventory the c Check payments. Thus, the ending inventory includes the capitalized c Check amount adjusted for the lower of cost or market. Effectively the cooperative is selling inventory forward to the next year and measuring its year end profit at lower of cost or market (LCM). This means that the product on hand at the end of the year is sold forward to the next year’s pool at the LCM and the next year’s pool will get any benefit or cost of a difference between the LCM and the actual amount realized on the c products.

Historically, the carry-out c product inventory represents less than one month’s sales and by the time the audit is completed, the majority of the carry-out c has been sold or committed in firm contracts. Thus, the net proceeds amount is assured.

The financial statements for Coop reflect the c Check payments to members as part of the inventory cost of the cooperative and, therefore, only the final payment, or patronage dividend, is reflected as part of the net income. The presentation on the tax return is the same as the financial statements. Form 990-C (and the new Form 1120-C) requires the cooperative to report per-unit retains paid in money in Schedule A (cost of goods sold). As will be discussed below, this does not change the fact that the full amount of the c Check and patronage dividend are section 1382(b) payments and may be deducted on the income tax return and may be added back for purposes of computing the section 199 deduction.

Nonexempt subchapter T cooperatives are permitted to exclude or deduct distributions to their patrons that qualify as patronage dividends or per-unit retain allocations, provided those distributions otherwise meet the requirements of subchapter T of the Code.

Section 1388(f) of the Code defines the term “per-unit retain allocation” to mean “any allocation, by an organization to which Part I of this subchapter 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 (PURs) may be made in money, property or certificates. Per-unit retain allocations paid in money (PURPIMs) 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 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 done 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.

Section 1382(a) of the Code provides that except as provided in section 1382(b), the gross income of any cooperative shall be determined without any adjustment (as a reduction in gross receipts, an increase in cost of goods sold, or otherwise) by reason of any allocation or distribution to a patron out of net earnings or by reason of any amount paid to a patron as per-unit retain allocations.

Section 1382(b)(1) of the Code provides, in part, that in determining the taxable income of a cooperative there shall not be taken into account amounts paid during the payment period for the taxable year as patronage dividends to the extent paid in money, qualified written notices of allocation, or other property with respect to patronage occurring during such taxable year.

Section 1.1382-2(b)(1) provides, in part, that there is allowed as a deduction from the gross income of any cooperative to which part I of subchapter T applies, amounts paid to patrons during the payment period for the taxable year as patronage dividends with respect to patronage occurring during such taxable year, but only to the extent that such amounts are paid in money, qualified written notices of allocation, or other property (other than nonqualified written notices of allocation). Section 1388(d) of the Code defines the term “nonqualified written notices of allocation” as meaning a written notice of allocation other than a qualified written notice of allocation, or a qualified check that is not cashed on or before the 90th day after the close of the payment period for the taxable year for which the distribution of which it is part is paid.

Section 1382(b)(3) of the Code provides, in part, that in determining the taxable income of a cooperative there shall not be taken into account amounts paid during the payment period for the taxable year as per-unit retain allocations paid in money, other property, or qualified certificates with respect to marketing occurring during such taxable year.

Section 1382(e) of the Code provides that for purposes of section 1382(b), in the case of a pooling arrangement for marketing products, the patronage shall be treated as occurring during the taxable year the pool closes, and the marketing of products shall be treated as occurring during any taxable years the pool is open.

Though section 1382 of the Code is awkwardly drafted, the flush language of section 1382(b) clarifies what it means for an item not to be “taken into account.” It states that, “for purposes of this title,” a patronage dividend is treated as “an item of gross income and as a deduction therefrom,” and a per-unit retain allocation in money or qualified certificates are treated as a “deduction in arriving at gross income.”

Section 1382(d) of the Code provides, in part, that the payment period for any taxable 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.

Thus, per-unit retain allocations paid in money or qualified certificates are deductions in arriving at gross income if paid with respect to an open pool within the payment period for the taxable year. Because patronage dividends paid in money and qualified certificates are treated as deductions in arriving at gross income, Form 990-C (and new form 1120-C) requires such dividends to be reported on Schedule H as a deduction from gross income. Because a per-unit retain allocations paid in money or qualified certificates are treated as a “deduction in arriving at gross income” they are reported on Schedule A of the Form 990-C which represents the cooperative’s cost of goods sold. This does not change the fact that Coop is allowed a full deduction under section 1382(b) of the Code for per-unit retains paid in money or qualified certificates.

We note that to prevent a cooperative from deducting the per-unit retain allocations made in money or qualified certificates for the second time when the associated product is sold, the cost of goods sold mechanism associated with inventory must be adjusted to reflect the deductions allowable under subchapter T. Specifically, cooperatives need to include the PURs 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 PURs. The adjustments can be made to either the inventory or the line item deduction for the PURs. In other words, if the PURs 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 PURs are not deducted on a deduction line in the tax return, the PURs 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 PURs once while also preserving the integrity of its section 263A calculation.

Under section 199(d)(3) of the Code, patrons that receive a qualified payment from a specified agricultural and horticultural cooperatives are allowed a deduction for an amount allocable to their portion of the 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 extracted (MPGE) 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 agricultural and horticultural products, the cooperative is treated as having 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), 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 of its return (provided that it does not create or increase a patronage tax loss), but is required under section 199(d)(3)(B) to reduce the deduction or exclusion it would otherwise claim under section 1382(b) for per-unit retain allocations and patronage dividends.

Section 1.199-6(l) of the Income Tax Regulations provides: "No double counting. 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) 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.

Section 1.199-6(k) provides that the final regulations are 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 the cooperative 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 he receives from the cooperative in his 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 199(d)(3) of the Code and the regulations thereunder.

Coop's c Checks qualify as per-unit retain allocations within the meaning of section 1388(f) of the Code because they were distributed with respect to c that Coop markets for its patrons, and by the fact that the patrons receive the payments based on the quantity of c delivered; the c Checks are determined without reference to the Coop's net earnings; the c Checks were paid pursuant to a contract with the patrons establishing the necessary pre-existing agreement and obligation; and the c Checks were paid within the payment period of section 1382(d).

Based on the foregoing, we rule as requested that:

> Section 199(d)(3) of the Code allows certain payments from the cooperative to its patrons to be added back for purposes of computing the section 199 amount. Coop should include all "net proceeds" payments or allocations, including the c Check and patronage dividend, in its computation of the section 199 amount. Specifically, the c Check is considered a per-unit retain paid in money under section 1382(b)(3).

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)