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LEGEND:

Taxpayer =

State A =

b =

Area

Dear :

This is in response to a request for rulings dated September 4, 2009, submitted by your authorized representative. The rulings concern the interplay of the rules in subchapter T of the Internal Revenue Code (concerning the taxation of cooperatives and their patrons) and the calculation of the section 199 deduction for certain cooperatives contained in section 199(d)(3).

Taxpayer is a farmers' cooperative organized as a cooperative corporation under State A law. Taxpayer files its federal income tax return (Form 1120-C) on the basis of a fiscal year ending on . Taxpayer's overall method of accounting for federal income tax purposes is the accrual basis.

Taxpayer is a nonexempt agricultural marketing cooperative under subchapter T of the Code. Taxpayer is organized as a marketing association under the State A Cooperative Marketing Act (the "Act"). .
Section provides:

> "Associations organized or domesticated hereunder shall be deemed nonprofit, inasmuch as they are not organized to make profits for themselves, as such, or for their members, as such, but only for their members as producers."

The Articles of Incorporation describe Taxpayer's purposes:

> "To engage in any activity involving or relating to the business of receiving, grading, processing, drying, packing, storing, financing, marketing, selling, and/or distribution, on a cooperative basis, of [b] or products or by-products derived therefrom of its members, or conducive thereto, and to engage in the handling of such [b] cooperatively either on an agency or a purchase and sale basis." Articles of Incorporation, Article .

Taxpayer's members are some b farmers located in Area. Each member has a current marketing agreement with Taxpayer. Each member also owns at least one share of Taxpayer's common stock, which is membership stock. Taxpayer's Articles of Incorporation provide that:

> "The common stock of this corporation may be purchased, owned or held only by producers who shall patronize the corporation in accordance with uniform terms and conditions prescribed thereby, and only such persons shall be regarded as eligible members of the corporation." Articles of Incorporation, Article .

The common stock has a par value of $ per share. Articles of Incorporation, Article . No dividends are paid on the common stock. Articles of Incorporation, Article . Article VI of the Articles of Incorporation provides 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 by him."

A significant portion of the b grown in the United States today is grown by b growers under contract with one or more of the . Taxpayer serves these and other b growers by providing an independent farmer-owned alternative to the large purchasers.

Taxpayer markets b on a pooled basis for its members. That b is delivered to Taxpayer for marketing pursuant to the terms of the b Marketing Agreement (the "Marketing Agreement"), which each member enters into with Taxpayer. Each year's crop is pooled separately.

Taxpayer purchases b from its members for marketing on a cooperative basis. Taxpayer then processes the b, removing the and placing the . The b in that form can be

. Taxpayer stores processed b at warehouses.

Taxpayer sells b to a variety of customers. Section of the Marketing Agreement authorizes Taxpayer to:

> "… contract in advance for the sale or all or part of the [b] [the b it acquires from members]; sell the [b] to dealers, manufacturers, brokers, or others, at wholesale, retail, auction, or otherwise, before or after manufacturing or processing, and within or outside this state; contract for the marketing of such [b] or its by-products through any commission houses, brokers, or agents selected by the Association, upon consignment or otherwise; fix a fair and reasonable price or prices at which such [b] or by-products may be sold; and fix whatever terms and conditions it deems advisable."

Taxpayer operates which receive b delivered by members pursuant to the Marketing Agreements to be marketed by Taxpayer as part of the annual pool. Taxpayer currently is operating strategically located across the territory it serves.

In addition, Taxpayer also purchases some b at the from nonmembers and from members outside of their Marketing Agreements. These purchases are not treated as member purchases. Nonmembers and members who sell b to Taxpayer in purchase transactions are not eligible to share in patronage dividends with respect to those transactions.

During , approximately of b were purchased by Taxpayer for marketing on a cooperative basis pursuant to the Marketing Agreements. The handled an additional of b acquired in purchases from nonmembers and members.

The focus of this ruling is on payments made by Taxpayer to members for their b pursuant to the Marketing Agreements. These payments are referred to in this ruling as the "b payments."

Taxpayer occasionally purchases b in purchase transactions from nonmembers, who have not entered into Marketing Agreements and are not entitled to share in patronage dividends. Taxpayer also occasionally purchases b in purchase transactions from members outside of the Marketing Agreements. As used in this ruling, the term "b payments" does not include payments made to nonmembers or to members for b acquired in purchases. The term "b payments" also does not include any patronage dividends that Taxpayer pays to members with respect to their pool b.

Section of the State A Cooperative Marketing Act specifically authorizes cooperative associations organized under that act to enter into marketing contracts with members:

> "(a) The association and its members may make and execute marketing contracts, requiring the members to sell, for any period of time, not over 10 years, all or any specified part of their agricultural products or specified commodities exclusively to and through the association or any facilities to be created by the association. The contract may provide that the association may sell or resell the products of its members, with or without taking title thereto, and pay over to its members the resale price, after deducting all necessary selling, overhead, and other costs and expenses, including dividends on preferred stock, not exceeding ten percent (10%) per annum, and reserve for retiring the stock, if any; and other proper reserves; and dividends not exceeding ten percent (10%) per annum upon common stock."

Taxpayer's Marketing Agreements are annual agreements, covering a single crop year and marketing season. Prior to the beginning of the year (typically in or), Taxpayer sets a target for the number of pounds of b that it is willing and able to acquire from members in the upcoming year for marketing on a cooperative basis. The target for is . Marketing Agreement, Section

Taxpayer then explains to members the marketing program for the upcoming year. Each grower interested in being part of the marketing program for the year is required to apply to be a part of the program by tendering a signed Marketing Agreement indicating the pounds of b the grower desires to deliver to Taxpayer for the year's pool. Marketing Agreement, Section . Taxpayer sets a deadline for members to make such an application. Taxpayer accepts or rejects applications based upon financial limitations, market conditions, the applicant's compliance with the provisions of previous marketing agreements, and guidelines approved by its board of directors.

After the deadline passes, Taxpayer totals the number of pounds covered by all accepted applications. If the total exceeds the target, then the number of pounds each grower is entitled to deliver "may be subject to adjustment so that the total pounds of [b] will approximate" the target. Marketing Agreement, Section . Taxpayer adjusts the poundage so that the total pounds in the Marketing Agreements totals approximately the target. Then,

> "(d) After the Association has calculated any adjustment pursuant to (c) above, it will return to Grower a fully executed Agreement setting forth in Section 1 the amount of his [b] poundage. If Grower does not wish to accept an Agreement for the [b] poundage set forth in his Agreement or wishes to reduce his

> [b] poundage, he shall provide written notice to the Association within ten (10) days after receipt of his executed Agreement." Marketing Agreement, Section .

The Marketing Agreement gives a member the right to deliver to the year's pool the specified poundage of b as part of the marketing program for the year. Members are not legally obligated to market all those pounds through Taxpayer. However, "[u]nless Grower delivers documented evidence satisfactory to the Association of crop loss or disaster preventing Grower's compliance," failure to deliver at least percent of the contract pounds, is regarded as a breach of the Marketing Agreement. Marketing Agreement, Section Among other things, Section provides the following remedies for breach by a Grower:

> "(b) If Grower breaches any provision hereof:
>
> (i) the Association shall, in addition to all remedies available at law or in equity, be entitled to enforce the sanctions set forth herein, including sanctions set forth in , or terminate this Agreement; and
>
> (ii) Grower may lose his eligibility to obtain a Marketing Agreement for 2010 or have his pounds reduced for 2010."

Breach of the Marketing Agreement is also a basis for terminating the membership of a member in Taxpayer. Marketing Agreement, Section

Members agree to raise b in accordance with all applicable federal and state laws and regulations which relate to the production, harvesting and sale of b. Marketing Agreement, Section In addition, members agree to comply with the rules and regulations relating to agricultural practices set forth in to the Marketing Agreement.

When b is harvested and ready for delivery, a member agrees to "deliver his [b] to the designated at his own expense." Marketing Agreement, Section There, prior to acceptance by Taxpayer, the b is inspected and graded. Marketing Agreement, Section The grade of b affects its value and what Taxpayer is obligated to pay for it. Taxpayer reserves the right to reject b that does not "grade within a grade eligible for purchase (' b') as set forth on , subject to the caps as set forth on Schedule A-2." Marketing Agreement, Section

Section of the Marketing Agreement provides that:

> "(b) [b] purchased by the Association shall be pooled by the Association. The Association shall endeavor to resell such [b], in its original form, or processed or manufactured, or as by-products, together with similar products or by-products delivered by other growers under similar agreements. Resale shall be at prices reasonably obtainable under market conditions, as determined by the Association in its discretion."

The Marketing Agreement provides for payment to members for their b when such b is accepted at a . Marketing Agreement, Section The payment amounts per pound of b are specified in of the Marketing Agreement. The amount paid depends upon the grade of the b as determined by the inspectors at the employing company grade standards. The same payment schedule applies to all members delivering b to Taxpayer under Marketing Agreements for a year.

The payment to members for their b is made by check at delivery. These payments are the "b payments" that are the subject of this ruling.

Taxpayer establishes what it will pay for b when Marketing Agreements are signed, which is prior to the beginning of the marketing year. Its policy is to set that payment at as high a level as possible based on anticipated marketing conditions. As a safety valve, in the event that b prices do not act in the manner expected, Taxpayer reserves the right to adjust the prices prior to the time that growers begin to deliver the b in the The Marketing Agreement provides:

> "(f) DUE TO ECONOMIC UNCERTAINTIES AND WORLD MARKET CONDITIONS, THE ASSOCIATION RESERVES THE RIGHT TO ADDRESS PRICES FOR B ON AT ANY TIME PRIOR TO THE OPENING OF THE FIRST ." Marketing Agreement, Section (capitalization in original).

Section of the Marketing Agreement provides for what is done with any net earnings of a pool (determined after subtracting amounts paid to members at the time of delivery):

> "(a) The Association may handle the pooled [b] or products in different ways, but the net proceeds of each pool, if any, less the costs of transporting, handling, processing, manufacturing, selling, storing, marketing products or by-products, and other activities, and also reserves (not to exceed 10% of the gross resale price) for general Association purposes, shall be divided pro rata among the growers in proportion to their deliveries of the [b] in such pool. The division or distribution shall be

made in the amounts deemed advisable by the Association's Board, in its discretion, until all the accounts of the season are completely settled."

Final payments made under this provision out of net earnings of a pool determined after the pool closes are patronage dividends.

Taxpayer began marketing b in the manner described above after the

. Since then, none of the pools covered by Marketing Agreements (i.e., the pools beginning in have yet closed, so patronage dividends have not been paid for those pools.

Because the rules are clear, no ruling is requested as to the treatment for section 199 purposes of patronage dividends that may be paid by Taxpayer.

Operating in the manner described above, Taxpayer made payments of approximately $ to members for their b during its fiscal year ended , . All of Taxpayer's b payments were made in cash (by check) and were paid in accordance with the Marketing Agreements in effect during the fiscal year ended Since no pools closed during the year, no patronage dividends were paid to members during the year.

Taxpayer has treated b payments as "purchases" for tax purposes and reported them on Schedule A, Line 2 of its Form 1120-C. Taxpayer has not reported 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.

Because of this reporting, b payments have entered into the determination of Taxpayer's cost of goods sold for tax purposes. Taxpayer does not sell all of the b received each year prior to year end, and so some b received during the year is in inventory at year end.

Taxpayer has done a section 199 computation in prior years. In that computation it has not added back b payments. Taxpayer has not passed any portion of its section 199 deduction through to members in prior years.

Taxpayer seeks to confirm that all b payments in cash to members should be classified as "per-unit retain allocations paid in money" and that they should be added back in its section 199 computation.

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 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 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.

Patronage dividends may be paid in money, property or written notices of allocation. Patronage dividends paid in money and in property are excludable or deductible under section 1382(b)(1) of the Code. Patronage dividends paid in written notices of allocation are deductible under section 1382(b)(1) if the written notices of allocation are qualified. If the notices are nonqualified, the cooperative is permitted a deduction under sections 1382(b)(2) (or a tax benefit figured under section 1383) when the notices are later redeemed.

Section 1388(b) of the Code provides that the term “written notice of allocation” means any capital stock, revolving fund certificate, retain certificate, certificate of indebtedness, letter of advice, or other written notice, which discloses to the recipient the stated dollar amount allocated to him by the organization and the portion thereof, if any, which constitutes a patronage dividend.

For cooperatives that use pooling, Rev. Rul. 67-333, 1967-2 C.B. 299, provides that pool advances are treated as per-unit retain allocations and the final pool payment, made after net earnings have been determined, is treated as a patronage dividend.

Section 199(a) of the Code provides taxpayers with a deduction for income attributable to domestic production activities. For taxable years beginning in 2009, that deduction is equal to 6 percent of the lesser of the qualified production activities income (QPAI) or of the taxable income (determined without regard to the deduction) of the taxpayer for the year.

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 (provided that it does not create or increase a patronage tax loss), but is required under section 199(d)(3)(B) to reduce the deduction or exclusion it would otherwise claim under section 1382(b) for per-unit retain allocations and patronage dividends.

Section 199(d)(3)(A) of the Code provides that a cooperative passes through an amount of its section 199 deduction by "identifying" such amount in a written notice mailed to such person during the payment period described in section 1382(d). Section 1382(d) provides that the payment period for a year is the period beginning with the first day of such taxable year and ending with the fifteenth day of the ninth month following the close of such year.

Section 1.199-6(g) of the regulations provide that in order for a patron to qualify for the section 199 deduction, section 1.199-6(a) requires that the cooperative identify in a written notice the patron's portion of the section 199 deduction that is attributable to the portion of the cooperative's QPAI for which the cooperative is allowed a section 199 deduction. This written notice must be mailed by the cooperative to its patrons no later than the 15th day of the ninth month following the close of the taxable year. The cooperative may use the same written notice, if any, that it uses to notify patrons of their respective allocations of patronage dividends, or may use a separate timely written notice(s) to comply with this section. The cooperative must report the amount of the patron's section 199 deduction on Form 1099-PATR, “Taxable Distributions Received From Cooperatives,” issued to the patron.

While a cooperative is permitted to disregard per-unit retain allocations and patronage dividends in its section 199 deduction, section 1.199-6(l) of the regulations provide that a qualified payment received by a patron of a cooperative is not taken into account by the patron for purposes of section 199.

Section 1.199-6(e) of the regulations define the term “qualified payment” to mean any amount of a patronage dividend or per-unit retain allocation, as described in section 1385(a)(1) or (3) of the Code received by the patron from a cooperative, that is attributable to the portion of the cooperative’s QPAI, for which the cooperative is allowed a section 199 deduction. For this purpose, patronage dividends and per-unit retain allocations include any advances on patronage and per-unit retains paid in money during the taxable year.

Taxpayer is a “specified agricultural or horticultural cooperative” within the meaning of section 199(d)(3)(F) of the Code and section 1.199-6(f) of the regulations. Taxpayer is an organization “to which Part I of subchapter T applies.” It is engaged in the marketing of agricultural or horticultural products (i.e., b).

As a specified agricultural or horticultural cooperative, Taxpayer is entitled to the benefit of section 199(d)(3)(C) of the Code and section 1.199-6(c) of the regulations which permit such cooperatives to disregard deductions under section 1382(b) and (c) for purposes of computing QPAI and taxable income for section 199 purposes. Section 1382(b) provides deductions for per-unit retain allocations paid in money, property and qualified per-unit retain certificates as well as for patronage dividends paid in money, property and qualified written notices of allocation. It also provides for deductions when nonqualified per-unit retain certificates and nonqualified written notices of allocation are redeemed.

Members marketing their b through Taxpayer are entitled to receive b payments when they deliver their b to a pool in accordance with Taxpayer’s Marketing Agreements. In addition, when a pool closes and the pool has net earnings above what are needed as reserves, members with b in the pool are entitled to a final pool distribution.

Taxpayer's b payments meet the definition of "per-unit retain allocations paid in money" which are excludible or deductible under section 1382(b)(3). Taxpayer's b payments are paid in money by check so the "paid in money" requirement is met. Taxpayer's b payments also meet all the requirements of the definition of "per-unit retain allocation" contained in section 1388(f), which defines the term "per-unit retain allocation" to mean any allocation, by an organization to which Part I of this subchapter applies, to a patron with respect to products marketed for him, the amount of which is fixed without reference to the net earnings of the organization pursuant to an agreement between the organization and the patron.

First, Taxpayer's b payments are paid to b growers pursuant to the State A Cooperative Marketing Act, Taxpayer's Articles of Incorporation and Bylaws, and Taxpayer's Marketing Agreements, and thus the "pursuant to an agreement" requirement is met.

Second, Taxpayer's b payments to a member are made "with respect to products marketed for him," namely, the b delivered by the member for marketing by Taxpayer.

Third, the amount of the b payments to each member "is fixed without reference to the net earnings" of Taxpayer since, at the time the payments are made, Taxpayer's actual net earnings for the pool are neither known nor determinable. When Taxpayer's net earnings for a pool are determined after the pool closes, if Taxpayer has net earnings which are not required as reserves, b growers are entitled to an additional distribution. This additional distribution is determined based upon Taxpayer's net earnings and is treated as a patronage dividend, not as a per-unit retain allocation.

Thus, Taxpayer's b payments meet all the requirements specified in subchapter T for per-unit retain allocations. Because all payments are in cash by check, they qualify as per-unit retain allocations paid in money.

Taxpayer has not reported its b payments in the manner that pooling cooperatives normally do. It has treated them as "purchases," not as "per-unit retain allocations paid in money or certificates." That does not mean that Taxpayer should be treated as a nonpooling cooperative. Taxpayer operates like pooling cooperatives do, where each person contributing to a pool each year receives the same amount for his or her crop (except for quality and other similar adjustments).

While there should be little doubt that Taxpayer is pooling the b received from members each year, whether or not Taxpayer is pooling is a moot issue for purposes of this ruling since 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 computations and then adjust the ending inventory and cost of goods sold to prevent double deduction of the per-unit retain allocations. The adjustments can be made to either the inventory or the line item deduction for the per-unit retain allocations. In other words, if the per-unit retain allocations are deducted on a deduction line in the cooperative's tax return, they should be removed entirely from the ending inventory and cost of goods sold computed for the tax year. Alternatively, if the per-unit retain allocations are not deducted on a deduction line in the tax return, the per-unit retain allocations reflected in the ending inventory should be removed and included in the cost of goods sold amount for that tax year. This procedure will allow the cooperative to deduct the per-unit retain allocations once while also preserving the integrity of its section 263A calculation.

For reasons described above, Taxpayer's b payments meet the definition of "per-unit retain allocations paid in money." Such per-unit retains are to be reported in box 3 of Form 1099-PATR, "Taxable Distributions Received From Cooperatives." Taxpayer should be entitled to disregard such payments in determining the amount of its section 199 deduction.

Accordingly, we rule as requested that:

1. Taxpayer's payments to members for b pursuant to the Marketing Agreements 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 such payments to members for b pursuant to the Marketing Agreements.

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)

cc: