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LEGEND:

Taxpayer =

State A =

Region =

Dear

This is in response to a request for rulings dated February 9, 2010, submitted by your authorized representative. The rulings concern the interplay of the rules in subchapter T of the Internal Revenue Code (concerning the taxation of cooperatives and their patrons) and the calculation of the section 199 deduction for certain cooperatives contained in section 199(d)(3).

Taxpayer is a farmers' cooperative organized under the Laws of State A. Taxpayer is a grain marketing cooperative serving farmers located in counties in Region. Taxpayer was organized in by grain growers interested in expanding the market for their grain. In particular, they thought that through cooperative efforts they could gain access to the grain market in . Taxpayer was successful in doing so. Over the years, it has established a reputation as a reliable source of high quality wheat and barley. In , Taxpayer purchased the agronomy business and equipment of and entered into the farm supply business. In , Taxpayer entered into the seed business.

Farmers in the Region principally raise wheat and barley. During its fiscal year ended , Taxpayer's grain sales were approximately $ million. In , Taxpayer purchased approximately million bushels of wheat and barley from its members and others. Principal grains marketed were soft white wheat (million bushels), dark northern spring wheat (million bushels), hard red winter wheat (million bushels) and barley (million bushels). Taxpayer also provides farm supplies to its members and others. Supply division sales totaled approximately $ million, including fertilizer, chemicals, seed and related services.

Taxpayer's "members" are producers of grain who do business with it. At , Taxpayer had members.

Taxpayer is organized and operated on a cooperative basis. The State A cooperative association statute describes cooperative associations as being organized "for mutual welfare" and the businesses of cooperatives as being operated "on the cooperative plan." .

More specifically, the statute provides:

> "The directors may apportion the net earnings [of a cooperative association] by paying dividends upon the paid-up capital stock at a rate not exceeding eight percent per annum. They may set aside reasonable reserves out of such net earnings for any association purpose. The directors may, however, distribute all or any portion of the net earnings to members in proportion to the business of each with the association and they may include nonmembers at a rate not exceeding that paid to members. The directors may distribute, on a patronage basis, such net earnings at different rates on different classes, kinds, or varieties of products handled. All dividends declared or other distributions made under this section may, in the discretion of the directors, be in the form of capital stock, capital or equity certificates, book credits, or capital funds of the association. All unclaimed dividends or distributions authorized under this chapter or funds payable on redeemed stock, equity certificates, book credits, or capital funds shall revert to the association at the discretion of the directors at any time after one year from the end of the fiscal year during which such distributions or redemptions have been declared."

Taxpayer's Articles of Incorporation authorize Taxpayer to engage in the grain business for its members, to "exercise generally the powers customarily exercised by cooperative associations" and to do so "on a nonprofit cooperative basis as agent for its members." Articles of Incorporation, Article 2, Section 1. Taxpayer's Bylaws repeat this, stating that Taxpayer "shall, at all times, be operated on a cooperative basis for the mutual benefits of its members." Bylaws, Article 8, Section 1.

The Articles of Incorporation authorize Taxpayer to issue a single class of common stock. Articles of Incorporation, Article 6, Section 1. That common stock has a par value of $30 per share and is entitled to receive a noncumulative dividend of not more than 8 percent per share as determined by the Board of Directors of Taxpayer. The common stock is membership stock. Each member of Taxpayer is required to purchase one share of common stock. Bylaws, Article 3, Section 2. Taxpayer's Bylaws limit membership to persons that are producers of agricultural products. Bylaws, Article 3, Section 1. The Bylaws provide that "[e]ach holder of Common Stock of the Association shall be entitled to one (1) vote in all matters wherein the shareholders of this Association shall be entitled to vote regardless of the number of shares of Common Stock owned by each such shareholder." Bylaws, Article 9, Section 2. At , there were shares of common stock issued and outstanding, entitled in the aggregate to a dividend of not more than $ per annum.

Taxpayer's Articles of Incorporation also authorize Taxpayer "to establish book credits, capital funds and other allocated reserves to provide funds for corporate purposes in the manner provided by the Bylaws by retains from net margins or proceeds otherwise payable to the members or patrons, or by other methods of collection." Articles of Incorporation, Article 7, Section 1. Book credits are issued as the noncash portion of the patronage dividends paid by Taxpayer to its members. They provide a significant source of equity capital for financing Taxpayer's business. At , the balance of book credits outstanding was $.

Taxpayer allocates and distributes its earnings each year from business done with or for members to its members in the form of patronage dividends. Article 8 of Taxpayer's Bylaws describes how Taxpayer computes and pays patronage refunds. In pertinent part, Section 3 provides:

> "Section 3. Obligation to Allocate Net Margins. Each business patronage transaction between the Association and a member shall be subject to and include as a part of its terms, the obligation of the Association to allocate as patronage dividends to such member, its net margin for each fiscal year … to the extent attributable to the business patronage by such members for such period. All such net margins of the Association from business patronage by its members shall be allocated and credited to the accounts of such members on a basis proportionate to the quantity or value of their individual business patronage with the Association."

That section of the Bylaws goes on to provide that Taxpayer "shall allocate net margins as patronage dividends to members separately by department."

> "The net margin of the Grain Marketing Department shall be allocated, as provided above, based upon the number of pounds of all grains marketed by members. The net margins of the Handling and Storage Department and the Farm Supply Department shall each be allocated, as provided

above based upon the dollar value of all business with members." (Bylaws, Article 8, Section 3).

Consistent with these directions, Taxpayer allocates patronage dividends each year on the basis three departments: grain marketing (with patronage dividends allocated based upon pounds), handling and storage (with patronage dividends allocated based on dollars of storage and handling fees paid by each member) and farm supply (with patronage dividends allocated based on dollars of supplies and service purchases by each member).

Article 8, Section 4 of the Bylaws authorizes Taxpayer to pay patronage dividends in cash and written notices of allocation (referred to by Taxpayer as "book credits"). The book credits may be qualified or nonqualified. Over the years, Taxpayer has issued both qualified and nonqualified written notices of allocation.

The Bylaws direct Taxpayer to retain any net margins attributable to business done with nonmembers not dealing with Taxpayer on a patronage basis and to any nonpatronage business (including any extraneous business with the federal government or its agencies). Bylaws, Article 8, Sections 10 and 11. Because Taxpayer does not do business with any nonmember patrons on a patronage basis, Taxpayer retains all net margins attributable to nonmember business. The amount of business conducted with nonmembers varies from year to year. In recent years, nonmember business has constituted approximately percent of Taxpayer's marketing business.

Taxpayer's Bylaws address what is to be done in the event of a loss. In general, the Bylaws permit losses to be netted between allocation units subject to some limitations. Bylaws, Article 8, Section 14. The Bylaws further provide that losses in a department "shall be allocated to all members who patronized such department or classification on the same basis as net margins are distributable hereunder." Bylaws, Article 8, Section 12.

In the event of dissolution, the Articles of Incorporation provide generally that assets shall be distributed in the following order of priority: first, to pay all debts; second, to pay holders of book credits an amount equal to the stated dollar amount; third, to pay common stockholders an amount equal to the par value; fourth, to pay current year patronage dividends, and fifth, to pay any allocated reserves to the persons to whom they are allocated. If any assets then remain, they:

> "… shall be distributed among the members of the Association in their respective proportion equal to the ratio that each member's dollar value of combined marketing and purchasing through the Association during the three (3) year period immediately preceding the date of such distribution shall bear to the total dollar value of all members combined marketing and

purchasing through the Association during such period by all members at such time." (Articles of Incorporation, Article 8, Section 8).

This ruling relates to Taxpayer's grain marketing activities. Taxpayer conducts its grain marketing through elevators Most of the grain that Taxpayer markets is destined for the bulk market. Taxpayer occasionally sells barley locally for livestock feed. In such instances, the customer will pick up the barley by truck at Taxpayer's elevator and Taxpayer will load it out for them. However, as in the case of wheat, most of the barley that Taxpayer markets is shipped by barge and is ultimately destined for the market.

Taxpayer's patronage grain business consists of buying grain from members, handling and storing the grain at its elevators, and selling the grain to customers. The principal issue in this ruling request relates to the characterization for purposes of subchapter T of the Code and section 199 of the amounts (referred to in this ruling as "grain payments") that Taxpayer pays its members for their grain when it acquires the grain for marketing on a patronage basis. For purposes of this ruling, the term "grain payments" does not include any amounts paid to persons not entitled to share in patronage dividends. For purposes of this ruling, the term "grain payments" also does not include patronage dividends paid to members of Taxpayer with respect to grain marketed for them.

Taxpayer does not operate on a pooling basis. Thus, Taxpayer's marketing proceeds are not shared equally on the basis of patronage and distributed in the form of harvest advances and progress payments with a final settlement after the pool closes as they would be if Taxpayer pooled. Commodity price risk does not automatically shift from Taxpayer's members to a pool at the time of harvest. Rather, it remains with members until they sell their grain to Taxpayer for marketing.

Taxpayer pays each member a market price for his or her grain. What that market price is depends upon where, when and how a member chooses to sell his or her grain to Taxpayer. That market price is determined without regard to the actual net proceeds from marketing grain. Payments are made in cash (by check) and occur throughout the year as members sell grain to Taxpayer for marketing and are paid pursuant to the terms of their individual contracts.

After purchasing grain from members, Taxpayer then markets each member's grain along with the grain of all of its other members in the manner that it judges will produce the best return. After year end, when net earnings for the year have been determined (after treating amounts paid to members for their grain as a cost of the grain), Taxpayer pays a patronage dividend to its members with respect to the grain they market through Taxpayer.

Grain farmers in the United States historically have retained the decision of to whom, when and how to sell their grain. The basic choices available to a member

selling grain to Taxpayer for marketing on a cooperative basis are: (i) to sell the grain for Taxpayer's current cash bid price, (ii) to sell the grain to Taxpayer using a fixed price forward contract, or (iii) to sell the grain to Taxpayer using a form of forward contract that leaves the price to be paid for the grain partly open and to be fully determined at a later date. These choices are similar to those offered farmers by commercial grain companies, though commercial grain companies do not market grain on a patronage basis and do not pay patronage dividends.

One way for a farmer to sell grain to Taxpayer for marketing is to sell the grain to Taxpayer and be paid the cash bid price. Members are responsible for delivering grain to one of Taxpayer's elevators. Members are responsible for the costs of shipping the grain from there to . The amount charged to members for handling and transportation is referred to as " " and "fuel surcharge" and set forth in a footnote on the cash bid schedule.

The cash bid prices are for grain that meets normal quality standards. Grain is weighed and tested when it is delivered by the member. If the grain includes such things as broken kernels and foreign matter, the weight is adjusted. If wheat is above or below certain protein standards, a premium is paid or a discount is charged.

A farmer can deliver and sell grain to Taxpayer at the cash bid price at the time of harvest, delivering the grain directly from the field. However, it usually is not advantageous for farmers to sell then since prices often are lowest at harvest. Many farmers have the capacity to store grain on farm and so can wait until later, when they think that the cash bid price is right, to deliver and sell their grain to Taxpayer. Other farmers deliver their grain to Taxpayer for storage, not for immediate sale. The farmers retain ownership of the grain in the elevator and pay storage fees to Taxpayer. Later, when a farmer believes the cash bid price is right, he or she can sell the grain to Taxpayer for marketing on a cooperative basis.

A farmer has the option of entering into a fixed price forward contract to sell his or her wheat to Taxpayer. Forward contracts call for delivery of a specified quantity and quality of grain, at a specified location, during a specified time period. Forward contracts can be entered into before the grain is planted, while it is growing or after harvest while the grain is being stored on the farm or in an elevator. The most common forward contract used by Taxpayer calls for a fixed price.

Farmers interested in entering into a forward contract with Taxpayer for wheat can determine the fixed price Taxpayer is willing to pay for delivery at various times in the future from Taxpayer's bid schedule for grain. Taxpayer is able to offer fixed price forward contracts for wheat and barley because it can hedge its price exposure by entering into corresponding fixed price forward contracts with its customers.

Farmers also can enter into forward contracts for wheat where the pricing is left partly open for future determination. This form of contract is referred to by Taxpayer as a "futures/cash purchase contract."

In the contract, one element of the price, the futures price for future delivery has been determined, but the basis has not been determined. The basis under this contract will be determined at a time specified by the farmer "on or before the delivery period." These contracts are not as common, but in recent years Taxpayer has offered this alternative in response to requests from its members. They are only offered to members.

On rare occasions, Taxpayer purchases grain from members on a deferred price basis (referred to by Taxpayer as a "no-price established" basis), where the price is left completely open. When Taxpayer purchases grain on this basis, title to the grain passes to Taxpayer, and it can sell the grain. The member retains the right to price the grain at Taxpayer's cash bid price at a date of his choosing (but not later than a set date). The benefit to the farmer is that he does not need to pay storage fees while waiting to price the grain since title to the grain passes to Taxpayer. These contracts are used when Taxpayer needs more company-owned grain to fill out a barge shipment. This option for selling grain to Taxpayer is not generally available to Taxpayer's members.

Some farmers prefer to sell their grain to Taxpayer on a deferred payment basis. Grain sold on that basis might be delivered in October, the price set at that time, but with payment to be made in January. Ownership of the grain passes to Taxpayer when the grain is delivered or at the time set in the agreement, with payment at a later date. Taxpayer does not have a separate form that it uses for deferred payment arrangements. When grain is purchased on that basis, the deferred payment date is specified on its normal contracts.

In summary, farmers can lock in prices for their wheat (even before the wheat is planted or while it is growing) at any time if they think that the price is right by using fixed price forward contracts. Some farmers prefer to enter into fixed price contracts after they can estimate the costs of production to lock in a reasonable margin. If a farmer is happy with the futures price of wheat, but not the basis, the farmer can enter into a forward contract that fixes the futures component of the price, but leaves the basis open.

If farmers think that the cash price is low at the time of harvest, they can harvest and store their grain while waiting for the price to improve. Farmers with grain in storage on the farm or at Taxpayer can then sell grain that is in storage at any time at the cooperative's cash bid price.

These choices are available to all farmers marketing their grain on a cooperative basis through Taxpayer. Because of these choices, two neighbors that market the

same quantity and quality of a particular kind of grain through Taxpayer during any year will receive different grain payments depending upon where, when and how they sell their grain to Taxpayer. However, they will receive the same patronage dividends with respect to grain marketing.

For the fiscal year ended , Taxpayer's grain payments to members exceeded $ million. Taxpayer paid patronage dividends to members with respect to their grain sales, supply purchases and handling and storage of . The patronage dividends were paid 45 percent in cash and 55 percent in qualified written notices of allocation (book credits).

Taxpayer historically has treated grain payments made in cash to members as "purchases" for tax purposes and reported them on Schedule A, Line 2 of its Form 1120-C. Taxpayer has not treated the grain payments made in cash as "per-unit retain allocations paid in money" and therefore has not reported them on Schedule A, Line 4b of its Form 1120-C. It has reported the patronage dividends paid to members as a patronage dividend paid in money and qualified written notices of allocation on Schedule H, lines 3a and 3b of its Form 1120-C.

Because of this reporting, grain payments paid in cash historically entered into the determination for tax purposes of Taxpayer's cost of goods sold for tax purposes. As is customary in the grain business, Taxpayer has valued its grain inventories at year end at market for financial statement and tax purposes.

Taxpayer has not added back grain payments in its section 199 computations for prior years. Taxpayer has not passed any portion of its section 199 deduction through to its members in prior years.

Recent developments have caused Taxpayer to reconsider how it should treat its grain payments for purposes of its section 199 computation. Taxpayer is seeking confirmation that all grain payments to members that are paid in cash should be classified as "per-unit retain allocations paid in money."

Taxpayer plans to disregard grain payments made to members for purposes of its section 199 computation. Taxpayer may retain all or a portion of its section 199 deduction or it may pass all of that deduction through to its members.

Based on the foregoing, Taxpayer requests the following rulings:

1. Grain payments to members 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 grain payments to members.

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

Section 1388(f) of the Code defines the term "per-unit retain allocation" to mean "any allocation, by an organization to which part I of [subchapter T] applies, to a patron with respect to products marketed for him, the amount of which is fixed without reference to net earnings of the organization pursuant to an agreement between the organization and the patron."

Per-unit retain allocations may be made in money, property or certificates. Per-unit retain allocations paid in money and in property are excludable or deductible under section 1382(b)(3) of the Code. Per-unit retain allocations paid in certificates are deductible under section 1382(b)(3) if the certificates are qualified. If the certificates are nonqualified, the cooperative is permitted a deduction under section 1382(b)(4) (or a tax benefit figured under section 1383) when the certificates are later redeemed.

Section 1388(a)(1) of the Code provides that the term "patronage dividend" means an amount paid to a patron by a cooperative on the basis of the quantity or value of business done with or for such patron. Section 1388(a)(2) provides that a "patronage dividend" is an amount paid "under an obligation" that must have existed before the cooperative received the amount so paid. Section 1388(a)(3) provides that "patronage dividend" means an amount paid to a patron that is determined by reference to the net earnings of the cooperative from business done with or for its patrons. That section further provides that a "patronage dividend" does not include any amount paid to a patron to the extent that such amount is out of earnings other than from business done with or for patrons. Section 1.1382-3(c)(2) of the Income Tax Regulations states that income derived from sources other than patronage means incidental income derived from sources not directly related to the marketing, purchasing, or service activities of the cooperative association.

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

Section 1388(b) of the Code provides that the term "written notice of allocation" means any capital stock, revolving fund certificate, retain certificate, certificate of

indebtedness, letter of advice, or other written notice, which discloses to the recipient the stated dollar amount allocated to him by the organization and the portion thereof, if any, which constitutes a patronage dividend.

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

Under section 199(d)(3) of the Code, patrons that receive a qualified payment from a specified agricultural or horticultural cooperative are allowed a deduction for an amount allocable to their portion of QPAI of the organization received as a qualified patronage dividend or per-unit retain allocation which is paid in qualified per-unit retain certificates. In particular, section 199(d)(3)(F) requires the cooperative to be engaged in the manufacturing, production, growth, or extraction in whole or significant part of any agricultural or horticultural product, or in the marketing of agricultural or horticultural products. Under section 199(d)(3)(D), in the case of a cooperative engaged in the marketing of agricultural and horticultural products, the cooperative is treated as having manufactured, produced, grown, or extracted (MPGE) in whole or significant part any qualifying production property marketed by the cooperative that its patrons have MPGE (this is known in the industry as the “cooperative attribution rule”). In addition, section 199(d)(3)(A)(ii) requires the cooperative to designate the patron’s portion of the income allocable to the QPAI of the organization in a written notice mailed by the cooperative to its patrons no later than the 15th day of the ninth month following the close of the tax year.

Under section 1.199-6(c) of the regulations, for purposes of determining a cooperative’s section 199 deduction, the cooperative’s QPAI and taxable income are computed without taking into account any deduction allowable under section 1382(b) or (c) of the Code (relating to patronage dividends, per-unit retain allocations, and nonpatronage distributions).

An agricultural or horticultural cooperative is permitted to “pass-through” to its patrons all or any portion of its section 199 deduction for the year provided it does so in the manner and within the time limits set by section 199(d)(3) of the Code. When a cooperative passes-through all or any portion of the section 199 deduction, the cooperative remains entitled to claim the entire section 199 deduction on its return, but is required under section 199(d)(3)(B) to reduce the deduction or exclusion it would otherwise claim under section 1382(b) for per-unit retain allocations and patronage dividends.

Section 199(d)(3)(A) of the Code provides that a cooperative passes through an amount of its section 199 deduction by “identifying” such amount in a written notice mailed to such person during the payment period described in section 1382(d). Section 1382(d) provides that the payment period for a year is the period beginning with

the first day of such taxable year and ending with the fifteenth day of the ninth month following the close of such year.

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

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

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

Taxpayer is a “specified agricultural or horticultural cooperative” within the meaning of section 199(d)(3)(F) of the Code and section 1.199-6(f) of the regulations. It is an organization “to which part I of subchapter T applies” (i.e., it is a nonexempt 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. Taxpayer purchases grain from members and markets the grain. The amount that each member receives when he or she sells grain to Taxpayer for marketing depends upon where, how, and when the member chooses to sell that grain to Taxpayer.

Members have a number of options for determining how and when sales are made. As a result, two neighbors delivering the same amount of grain to Taxpayer during any year will be paid different amounts for that grain depending upon where, when and how they sell the grain to Taxpayer. However, all members share in Taxpayer's net earnings from marketing operations in proportion to the quantity of grains they market through Taxpayer. Those net earnings are distributed after the end of each year in the form of patronage dividends paid in cash and qualified written notices of allocation (book credits).

The question presented in this ruling is whether the grain payments made by Taxpayer to patrons for grain 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 members are per-unit retain allocations paid in money, then they should be added-back in Taxpayer's section 199 computation and not included in the members' section 199 computations. If the grain payments to members are not per-unit retain allocations paid in money, then they should not be added-back in Taxpayer's section 199 computation, but should be included in the members' section 199 computations. These results are the same whether Taxpayer decides to keep or to pass-through all or a portion of its section 199 deduction.

Marketing cooperatives like Taxpayer have never thought of their grain payments as per-unit retain allocations paid in money. However, Taxpayer's grain payments appear to meet the definition of "per-unit retain allocations paid in money" which are excludible or deductible under section 1382(b)(3) of the Code. The grain payments are made in cash so the "paid in money" requirement is met.

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."

First, Taxpayer's grain payments to a member are paid "pursuant to an agreement," namely the particular agreement applicable to the method the member uses to determine how and when his or her grain is sold to Taxpayer.

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

Third, the amount of the grain 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 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 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."

Historically, Taxpayer has treated its grain payments as "purchases," not as "per-unit retain allocations paid in money." However, how the payments have been reported should not obscure what they really are.

Whether or not Taxpayer is pooling is a moot issue for purpose of this ruling because its grain 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 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 crop payments to members and other 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, "Taxable Distributions Received From Cooperatives." If properly treated as per-unit retain allocations paid in money, then Taxpayer will be entitled to disregard such payments in determining the amount of its section 199 deduction.

We note that payments to nonmembers who are not eligible to share in patronage dividends (i.e., those with whom Taxpayer does not operate on a cooperative basis with) do not constitute per-unit retains paid in money within the meaning of section 1382(b)(3) of the Code and, accordingly, are treated exclusively as purchases in the cost of goods sold mechanism.

Accordingly, we rule as requested that:

1. Grain payments to members 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 grain payments to members.

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

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

Sincerely yours,

Paul F. Handleman

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