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LEGEND:

Taxpayer =

State A =

Subsidiary 1 =

Subsidiary 2 =

b =

c =

Dear

This is in response to a request for a ruling dated August 16, 2011, submitted by your authorized representatives. 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).

Taxpayer is a nonexempt agricultural cooperative corporation organized and existing under the laws of State A. Subsidiary 1 is a percent owned subsidiary of Taxpayer and is also a nonexempt agricultural cooperative corporation organized and existing under the laws of State A. An unrelated cooperative corporation owns the other percent of Subsidiary 1. Subsidiary 2 is a wholly owned subsidiary of Taxpayer and is a nonexempt agricultural cooperative corporation organized and existing under the laws of State A (collectively, “Subsidiaries”). The members of Taxpayer are b farmers located principally in State A who deliver their c to Taxpayer. Each member signs a

Producer's Contract with Taxpayer, but may deliver c to a plant owned by Taxpayer or Subsidiary 1. Subsidiary 2 owns a plant that is currently not operating and is being held for sale. Subsidiary 2 is otherwise inactive. Taxpayer and Subsidiaries have a calendar year end. Taxpayer operates c processing plants, and also transfers c to Subsidiary 1 as needed for processing in its plants. Taxpayer represents that all intercompany transactions are properly eliminated in the consolidated federal return. Subsidiary 1 processes c into a variety of b products and then markets those products. At the end of each year, Taxpayer and Subsidiaries compute their respective net proceeds. Subsidiary 1 distributes patronage income on a patronage basis to its parent, Taxpayer (net of the minority interest portion of Subsidiary 1's patronage net proceeds, which is distributed to the minority interest owner). Such amounts received by Taxpayer are for distribution to its members, along with Taxpayer's own patronage income.

The Taxpayer's Producer's Contract and Bylaws clearly state that the cooperative must distribute the net proceeds, but like many other b cooperatives around the United States, Taxpayer and Subsidiaries have capitalized a portion of the net proceeds, known as the "c-Check," into inventory. The total amount of the c-Check for the December 31, 2010 year was approximately $ million. The patronage dividend for the December 31, 2010 year was approximately $ million.

The Producer's Contract states in Section 10 that "[t]his Contract is intended to constitute a marketing contract as provided by Section 70 of the Cooperative Corporations Law of the [State of A]...The Producer... authorizes [Taxpayer] to perform any and all services or operations on his behalf authorized or permitted by statute..."

Section of the Cooperative Corporations Law of the State of A provides in part, that "[t]he marketing contract may provide that the corporation may sell or resell the products delivered by its members, with or without taking title thereto; and may pay over to its members the resale-price, or the pool price in case of pooling of sales, after deducting all necessary selling, overhead and other costs and expenses..." The Producer's Contract further states in Section 2 that "[Taxpayer] may sell or resell such [c] with or without taking title thereto, or may process or manufacture the same and sell the products thereof..."

Article III, Section 4b of the Taxpayer's Bylaws states that "[t]he producer member agrees that title to the [c or b] products sold to the Cooperative shall pass to the Cooperative upon acceptance by the Cooperative of the [c or b] products conforming to its quality control requirements. 'Acceptance' by the Cooperative shall be such time as the [c] is commingled with other [c]."

Despite the language in the Producer's contract that allows the Taxpayer to "sell such [c] with or without taking title," the Bylaws make clear in Article III, Section 4b, and it is the Taxpayer's regular and ordinary business practice to take title and the full

benefits and burdens of ownership to all c delivered to it by its members upon acceptance by the Taxpayer.

A member may deliver c directly to a plant that is owned by the Taxpayer or a plant that is owned by Subsidiary 1. In all cases, upon acceptance of the c, title and the benefits and burdens of ownership of the c passes to the Taxpayer. In cases where the c is actually delivered to a plant owned by Subsidiary 1, there is an immediate deemed transfer of the c by Taxpayer to Subsidiary 1 in an intercompany transaction. Such intercompany transfers of c from the Taxpayer to Subsidiary 1 are properly eliminated in determining the consolidated taxable income.

The Taxpayer's Bylaws further state, at Article III, Section 4d, that Taxpayer may "blend the proceeds received from its sale of [c] and other [b] products of the members with proceeds received from sale of such products of some or all other members and may distribute such blended proceeds subject to adjustment for differentials and deductions..."

Accordingly, Taxpayer pools the c delivered by members and the proceeds from the related sale of c and other b products produced from member c for purposes of determining the financial results of the pool. Taxpayer has consistently employed an annual pool, beginning on January 1 and ending on December 31. The Taxpayer's Bylaws state at Article VIII, Section 7, that "[a]s soon as practicable following the end of each fiscal year, the Cooperative shall separately determine the net proceeds from member, non-member and non-patron business. The net proceeds for each of these business categories shall be determined by deducting from applicable gross proceeds the payments to patrons and/or costs and expenses as allocated to each business category on a basis deemed appropriate. Net proceeds from member business shall be allocated to members in the proportion that the of [c or c] equivalent marketed by each member through the Cooperative during the fiscal year bears to the total of [c or c] equivalent marketed by all such members through the Cooperative during such fiscal year or on such other equitable basis as approved by the Board of Directors." Section 8 of the Bylaws further provides that "[t]he net proceeds allocated to members (patrons) shall be distributed within eight and one-half (8 1/2) months following the close of the fiscal year."

These provisions of the Bylaws establish the pre-existing legal obligation of Taxpayer to pay the members their proportionate share of the net proceeds based on the volume of their c deliveries.

Taxpayer makes payments to its patrons each year pursuant to the Member Producer's Contract and Bylaws, 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 Producer's Contract and the Bylaws provide that the member receives one or more advances following delivery and acceptance of the

member's c. The total amount of the "c-Checks" paid to members for the year ended December 31, 2010, was approximately $ million.

Article VIII, Section 5 of the Bylaws provides that "[f]or each calendar month, the Cooperative shall make such uniform advances to patrons on c and c products of the same grade and quality following its delivery as in the discretion of the Board of Directors may be reasonable in view of market conditions and the financial condition of the Cooperative. In making any such payments, the Board of Directors shall have the right to establish equitable differentials based upon, but not limited to variations in market prices, grades, quality, location of product delivered, and transportation, and may deduct and retain out of the amount payable to patrons such sums per of [c] delivered as the directors may determine from time to time to be necessary or desirable."

Taxpayer has historically made payments to members on or about the and the of each month for deliveries in the previous month for these advances in accordance with Section 7 of the Producer's Contract. These payments are also known as "c-Checks." Taxpayer estimates the c price for the previous month for the payment on the of the month, and uses the final c price for the previous month for the payment on the of the month. Payments made on the of the month are adjusted to account for amounts paid on the of the month. The amounts are further adjusted for quality, volume, and certain other premiums consistent with industry practice. This advance amount keeps the cooperative competitive with non-cooperative c processors. However, this amount is merely an advance on the ultimate net proceeds of the annual pool due to the member under the Member Producer's Contract and Bylaws.

At the end of the year, Taxpayer distributes the remaining amount of the net proceeds to the patrons. 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, net of any amounts withheld for reasonable reserves. The final payment is considered a "patronage dividend" for federal income tax purposes, and there is a requirement under section 1388(c) of the Code that at least 20 percent of the patronage dividend be paid in cash.

As described in the Producer's Agreement and the Bylaws, Taxpayer 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 the 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 sales 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.

Taxpayer's pooling arrangement is that a separate pool is opened with each fiscal year. Taxpayer is using the "closed pool" method in its financial statement and tax return accounting. Taxpayer 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, Taxpayer's inventory includes c, and other b products. Because the majority of the products Taxpayer sells are , year end inventory levels are usually relatively low, as a function of annual sales. For example, for the fiscal year ended December 31, 2010, the overall inventory turned approximately times during the year. Accordingly, virtually all of the products in inventory at year end are sold within a month of year end. In addition, the membership base is stable and the members understand the valuation method being used and have always accepted the closed pool methodology.

The financial statements for Taxpayer reflect the c-Check payments to members as part of the inventory costs of the cooperative and therefore only the final payment, or patronage dividend, is reflected as part of Net Income. The presentation on the tax return is the same as the financial statements. Form 1120-C requires the cooperative to report per-unit retains paid in money in Schedule A (Cost of Goods Sold). The Taxpayer has reported the c check payments on the line in Schedule A designated for reporting per-unit retains paid in money. This presentation 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.

Based on the foregoing Taxpayer request a ruling 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 deduction.

Taxpayer should include all "net proceeds" payments or allocations, including the c-Checks and patronage dividends, in its computation of the section 199 deduction. Specifically, a "c-Check" is considered a "per-unit retain paid in money" under section 1382(b)(3).

The Taxpayer maintains inventories and, in doing so, claims it properly capitalizes processing, ingredient and packaging expenses, including labor and overhead expenses as required by sections 263A and 471 of the Code and the regulations thereunder. The c-Check payments, whether in cash or certificate form, are also being capitalized to cost of inventory.

Net proceeds for the fiscal year is determined using the accrual basis, and computed by including, among other things, the LCM for the unsold c products from the patrons that remains in stock at the end of the year. Any unsold product is essentially sold forward to the next year's inventory at the LCM value. This is done pursuant to the closed pool method of accounting for a pool whereby the patrons receive the net proceeds of the fiscal year rather than the net proceeds of the entire period that the c products from that fiscal year are in stock (open pool method).

The membership of Taxpayer has remained relatively stable over the years, and Taxpayer has always used the closed pool method to measure net proceeds. The closed and open pool methods will yield the same result for the net proceeds over time to the patron, and where membership is stable; the result is fair and equitable. The Taxpayer believes the portion of the LCM amount related to the c-Check to the patron is therefore not a section 263A or 471 inventory amount, but rather a section 1382(b) amount.

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

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

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

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

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

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

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

Under section 199(d)(3) of the Code, patrons that receive a qualified payment from a specified agricultural or horticultural cooperative are allowed a deduction for an amount allocable to their portion of qualified production activities income (QPAI) of the organization received as a qualified patronage dividend or per-unit retain allocation which is paid in qualified per-unit retain certificates. In particular, section 199(d)(3)(F) requires the cooperative to be engaged in the manufacturing, production, growth, or extraction in whole or significant part of any agricultural or horticultural product, or in the marketing of agricultural or horticultural products. Under section 199(d)(3)(D), in the case of a cooperative engaged in the marketing of agricultural and horticultural products, the cooperative is treated as having manufactured, produced, grown, or extracted (MPGE) in whole or significant part any qualifying production property marketed by the cooperative that its patrons have MPGE (this is known in the industry as the “cooperative attribution rule”). In addition, section 199(d)(3)(A)(ii) requires the

cooperative to designate the patron's portion of the income allocable to the QPAI of the organization in a written notice mailed by the cooperative to its patrons no later than the 15th day of the ninth month following the close of the tax year.

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

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

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

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

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

Section 1.199-6(e) of the regulations defines the term "qualified payment" to mean any amount of a patronage dividend or per-unit retain allocation, as described in

section 1385(a)(1) or (3) of the Code received by the patron from a cooperative, that is attributable to the portion of the cooperative's QPAI, for which the cooperative is allowed a section 199 deduction. For this purpose, patronage dividends and per-unit retain allocations include any advances on patronage and per-unit retains paid in money during the taxable year.

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

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.

The question presented in this ruling is whether the c-Check payments made by Taxpayer to members for b qualify as per-unit retain allocations paid in money within the meaning of section 1388(f) of the Code.

Under section 199 of the Code and section 1.199-6 of the regulations, the answer to this question determines who gets to include the c-Check payments in the section 199 computation. If the c-Check 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 c-Check 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.

Taxpayer's c-Check payments also meet all the requirements of the definition of "per-unit retain allocation" contained in section 1388(f) of the Code, which defines the term "per-unit retain allocation" to mean "any allocation, by an organization to which part I of this subchapter applies, to a patron with respect to products marketed for him, the amount of which is fixed without reference to the net earnings of the organization pursuant to an agreement between the organization and the patron."

This meeting of the minds between the cooperative and the member or patron must be evidenced by clear and timely evidence showing that the payment was a per-unit retain allocation and not sale proceeds, and, subsequent, consistent treatment of the payment as a per-unit retain allocation by the cooperative.

First, Taxpayer's c-Check payments to a member are paid "pursuant to an agreement," namely the Producer Contract and Bylaws. The agreement required in section 1388(f) of the Code is an agreement between Taxpayer and the member that the amount is a per-unit retain allocation and does not represent proceeds from a sale to the cooperative. Reporting c check payments as per-unit retain allocations paid in money in box 3 of Form 1099-PATR demonstrates that Taxpayer and the member agreed to treat c check payments as per-unit retain allocations paid in money and not sales.

Second, Taxpayer's c-Check payments to the patrons are made "with respect to products marketed for him," namely, the c delivered for marketing by Taxpayer

Third, the amount of the c-Check 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."

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 Taxpayer 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 Taxpayer in the patron's own section 199 computation whether or not the cooperative keeps or passes through the section 199 deduction. Accordingly, the only way that a patron can claim a section 199 deduction for a qualified payment received from a cooperative is for the cooperative to pass-through the section 199 amount in accordance with the provisions of section 199(d)(3) of the Code and the regulations thereunder.

We note that to prevent a cooperative from deducting the per-unit retain allocations made in money or qualified certificates for the second time when the associated b is sold, the cost of goods sold mechanism associated with inventory must be adjusted to reflect the deductions allowable under subchapter T of the Code. Specifically, cooperatives need to include the per-unit retain allocations in inventory cost for purposes of making inventory and section 263A of the Code computations and then adjust the ending inventory and cost of goods sold to prevent double deduction of the per-unit retain allocations. The adjustments can be made to either the inventory or the line item deduction for the per-unit retain allocations. In other words, if the per-unit retain allocations are deducted on a deduction line in the cooperative's tax return, they should be removed entirely from the ending inventory and cost of goods sold computed for the tax year. Alternatively, if the per-unit retain allocations are not deducted on a deduction line in the tax return, the per-unit retain allocations reflected in the ending inventory should be removed and included in the cost of goods sold amount for that tax year. This procedure will allow the cooperative to deduct the per-unit retain allocations once while also preserving the integrity of its section 263A calculation.

For the reasons described above, Taxpayer's c-Check payments to members meet the definition of "per-unit retain allocations paid in money." The per-unit retains must be treated as such for all purposes of the Code and are reported in box 3 of Form 1099-PATR. If properly treated as per-unit retain allocations paid in money, then Taxpayer will be entitled to disregard such payments in determining the amount of its section 199 deduction.

Accordingly, 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 deduction. Taxpayer should include all "net proceeds" payments or allocations, including the c-Checks and patronage dividends, in its computation of the section 199 deduction. Specifically, a "c-Check" is considered a "per-unit retain paid in money" under section 1382(b)(3).

No opinion is expressed or implied regarding the application of any other provision in the Code or regulations.

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

Sincerely yours,

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

cc: