Legal-Tax-Accounting Memorandum

NATIONAL COUNCIL OF FARMER COOPERATIVES

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LTA Memo 2015-1 **February 25, 2015**

LLC's Purchases of Grain from Cooperative Members Are Not PURPIMs, IRS Concludes

In a Chief Counsel Memorandum, the IRS has ruled that a cooperative may not treat its partner LLC's grain purchases as PURPIMS.

The grain cooperative at issue joined with two other cooperatives to form a Delaware limited liability company (LLC) that is taxed as a partnership. The cooperative contributed its grain marketing and warehousing businesses to the LLC, and sold its grain inventory to the LLC. The cooperative also surrendered its grain dealer's license, agreed not to compete with the LLC, and leased employees to the LLC to manage the business.

The LLC purchases grain from the cooperative's current or former patrons. Agreements to purchase grain are between the LLC and the grain producers. The cooperative calculated its Section 199 domestic production activities deduction (DPAD) taking into account the amounts passed through by the LLC to the cooperative.

In a Chief Counsel Memorandum, the IRS concluded that the LLC's grain purchases do not qualify as deemed per-unit retain allocations because the LLC does not operate under Subchapter T. The IRS reasoned that the cooperative is permitted to distribute its net margins from the LLC's operations as patronage dividends, but added:

> However, no part of the purchase price the LLC paid to the [cooperative's] patrons for their grain is a per-unit retain allocation. A payment to a cooperative's patron for the purchase of grain cannot be a per-unit retain allocation paid in money unless the amount is paid by an entity subject to the provisions of subchapter T and paid pursuant to an agreement between a cooperative and its patron. Since the [cooperative] was not a party to the sale contracts between its "patrons" and the LLC, the payments do not meet the definition of a per-unit retain allocation.

Once again, the IRS cited the Farm Service case (*Farm Service Cooperative v. Commissioner*, 619 F.2d 718, 980, (8th Cir. 1980)) for the proposition that a cooperative must separately calculate patronage and nonpatronage sourced income.

The memorandum was reviewed by Paul Handleman and Patrick McGroarty in the IRS National Office. Chief Counsel Memorandum 20150801F is dated April 22, 2014, and was released February 20, 2015.

Office of Chief Counsel
Internal Revenue Service
Memorandum

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CC:LB&I:RFPH:CH2:RAVillageliu
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from: Rogelio A. Villageliu
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subject: , formerly known as
Years: and
S/L: and

This responds to your request for an opinion regarding the above-reference taxpayer. This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney-client privilege. Pursuant to your informal inquiry, we have analyzed the information that this opinion contains from the point of view of the attorney-client privilege and other privileges and there will be no harm to the Service from disclosing any of the information set forth in this opinion or from showing or handing a copy of this opinion to the above-named taxpayer, if you deem this to be helpful in handling your case. You should not provide a copy of this opinion to anyone other than the taxpayer or its properly authorized representative, as it does contain taxpayer specific information that cannot be disclosed to third-parties.

The request covers the two current years under Examination: and .
The two prior years, and , are in Appeals for the same issue.

ISSUE: Can (the Taxpayer), a non-exempt cooperative under Subchapter T and partner in an LLC taxable as a partnership, treat the partnership's grain purchases as the

Taxpayer's PURPIM under Internal Revenue Code § 1388(f) if the partnership purchases grain from the Taxpayer's current or former patrons?

Answer: No. Assuming the partnership is not an agent of the Taxpayer, the Taxpayer cannot treat the partnership's grain purchases as the Taxpayer's PURPIMS because the Taxpayer did not purchase the grain from its current or former patrons.

A limited liability company ("LLC") taxable as a partnership, that is neither a cooperative nor an agent of a cooperative with respect to the company's grain purchases, and has the burdens and benefits of ownership of these grain purchased from patrons or former patrons of one of its members, that operates on a cooperative basis, can neither issue nor create PURPIMs ("per-unit-retain-paid-in-money") of its own within the meaning of I.R.C. §1388(f) or of Subchapter T of the Code. The LLC's grain purchases are not the purchases of its cooperative member, merely because these purchases are made from the cooperative's former or current patrons. The cooperative surrendered its grain dealer's license. The fact that the LLC is taxable as a partnership for federal income tax purposes and that the cooperative member's income from the LLC flows through to the cooperative member (as if the cooperative were a partner) is irrelevant, as the LLC itself, is not a cooperative and, thus, cannot ascribe to itself the attributes and ability of a member cooperative to issue PURPIMs.

Proposed Adjustment

Line 22 Domestic Production Activities Deduction (DPAD)		
Per Return Per Exam		
DPAD Increase (Decrease)		
Taxable Income Increase (Decrease)		

We concur with the proposed decreases to the taxpayer's claimed domestic production activity deduction and the resulting increases to the taxpayer's taxable income set forth above.

FACTS

The facts are as determined by the Examination Division, Revenue Agent Gale W. Jesse. This opinion assumes the facts to be true as determined. If further factual determinations were to alter the material facts, this may result in a different opinion.

formerly known as ("the Taxpayer") is a nonexempt agricultural cooperative organized in under the Agricultural Co-operative Act. The Taxpayer's primary operations are in . The Taxpayer reports its taxable income on Form 1120-C and files on a tax year.

The Taxpayer's Articles of Incorporation (as amended) set forth in Article 2 the stated purposes for which the cooperative was formed, including:

(a) "To engage in any cooperative activity for the mutual benefit of its common stockholders and patrons in connection with the purchasing or distribution of farm supplies or the production, marketing or selling of agricultural products"

(b) "To purchase, handle, store, deal in, market and sell grain, soybeans and other agricultural commodities."

By the terms of its Articles of Incorporation and By-Laws, the Taxpayer is organized with capital stock, both preferred and common. Several classes of preferred stock have been authorized and issued, each with specific preferences and privileges as to dividends, voting and distribution of assets upon liquidation.

No preference as to dividends is granted to the common stock, which can only be issued to producers of agricultural products who are also members of Agricultural Association and a County Farm Bureau. A producer who meets these requirements will be entitled to one share of common stock upon patronizing the company. Each share of common stock entitles the holder to one vote at shareholders' meetings.

After paying any dividends on capital stock declared by the board of directors and after setting aside reasonable and adequate reserves, the Taxpayer is required to distribute its remaining net earnings on the basis of patronage to its members and other patrons who meet the requirements to participate in patronage distributions. The Taxpayer's members are its common stockholders. Other producers that patronize the cooperative but who are not common stock holders may also be eligible to receive patronage distributions if they meet certain requirements.

Taxpayer Grain Operations Pre-Limited Liability Company ("LLC") taxable as a Partnership

One of the commodities that the Taxpayer purchased, stored, marketed and sold was grain. The Taxpayer purchased grain from its patrons, who are generally individual farmers, and sold the grain to customers (typically end processors). The Taxpayer recorded the grain purchases, inventory and sales on its books and reported these transactions on its 1120-C tax return. This was the business model for the grain activity prior to the formation of the LLC.

LLC taxable as a Partnership Formation –

In the Taxpayer joined with two other cooperatives to form a Delaware limited liability company, ("the Company", the "LLC" and the "Partnership"). (Note that the LLC was not legally formed as a partnership, but it chose to be taxed as a partnership for federal income tax purposes). The LLC is a licensed grain dealer that files as a partnership for federal income tax purposes on an tax year.

Under the terms of a Contribution and Subscription Agreement, in exchange for a interest in the LLC, the Taxpayer agreed to:

1. contribute its grain marketing and warehousing businesses to the LLC, including land, grain facilities and equipment, transportation equipment, grain accounting software and certain intangible assets,

2. sell its grain inventory to the LLC at current replacement cost,

3. surrender its grain dealer's license,
4. sign an agreement not to compete with the LLC, and
5. lease certain employees to the LLC to manage the business, operate the grain facilities, market the grain and keep the books.

The other two LLC members contributed cash that was used to purchase the assets of two commercial grain operations, including elevator complexes, equipment, inventory and intangibles. While the other members provided a full range of agricultural supplies and services to their patrons, unlike the Taxpayer, neither of the other members purchased grain from or marketed grain for their patrons.

The LLC's operating agreement states in section 5.1 Tax Matters: "It is the intention of each Member that the Company shall be classified as a partnership for federal income tax purposes, and if for any reason at any time it appears the Company may be classified as an association taxable as a corporation (or otherwise be subjected to an entity-level Federal income tax), then each Member agrees and authorizes the Board to amend this Agreement in such a manner as the Board determines shall be necessary to carry out the intent of the Members that the Company be taxed as a partnership, without the requirement of additional Member consent."

As a result of the operating agreement, the LLC files a partnership tax return (Form 1065) for federal income tax purposes. The LLC is not a cooperative and thus does not have the tax attributes of a cooperative. The agreements to purchase grain are between the LLC, which is a licensed grain dealer, and the grain producers. There is no written documentation that indicates any type of agency relationship between the LLC and the Taxpayer, with regard to the LLC's grain purchases.

Post-LLC formation there are no Taxpayer grain purchases but only LLC grain income a share of which flows-through to the Taxpayer from the LLC

After the LLC formation, the Taxpayer is no longer in the grain business: it is no longer a licensed grain dealer since it surrendered its grain license. Any purchases and sales of grain by the Taxpayer in the capacity of a licensed grain dealer would violate the non-compete clause with the LLC. The Taxpayer's patrons that formerly sold grain to the Taxpayer now sell grain to the LLC (if they choose to do so, they are not obligated to sell grain to the Partnership).

and LLC Operations, Books and Tax Returns

The LLC buys, stores, markets, and sells the grain. The purchases, inventory and sales of the grain are recorded on the LLC's books and reported on the Form 1065 Partnership return. Schedule K-1s are issued to the three members of the LLC (the Taxpayer and the other 2 members, all taxable as partners for federal income tax purposes).

For the years and , the LLC issued K-1s to the Taxpayer passing through the Taxpayer's of the Domestic Production Gross Receipts ("DPGR"), cost of goods sold, and wages related to the Domestic Production Activities Deduction ("DPAD").

and Taxpayer Return – DPAD ("Domestic Production Activity Deduction")

The Taxpayer calculated its and DPAD taking into account the amounts passed through by the LLC taxable as a Partnership for federal income tax purposes.

For the year , the LLC passed through DPGR of , cost of goods sold of , and the deductions and losses allocable to DPGR of . This would yield Qualified Production Activities Income ("QPAI") related to the LLC of . However, the Taxpayer reduced the cost of goods sold by "adding back" , in effect making the cost of goods sold zero and the QPAI , from the LLC. The Taxpayer's position for the "add back" is that the purchases of grain made by the LLC from the Taxpayer's "patrons" are deemed "per-unit-retains paid-in-money" ("PURPIM").

The Taxpayer also included activities from its own operations in the DPAD. The Taxpayer's DPGR, cost of goods sold, and deductions and losses allocable to DPGR for its own operations yielded a negative QPAI of . However, due to the large QPAI from the LLC, in total, the QPAI netted to a positive .

The Taxpayer had wages of from its own operations and from the LLC. DPAD is the lesser of 6% of QPAI, which was , or 50% of wages, which is . As a result, the Taxpayer computed a DPAD of for tax year .

It should be noted that the deemed "PURPIM" in the Taxpayer's own computation is not . The reason for this is that Taxpayer's patrons typically sell more grain to the LLC (the LLC's purchases from the Taxpayer's "patrons" on average of the LLC's total purchases) than the Taxpayer's ownership. The Taxpayer thus has "capped" the PURPIM at in their computation, reducing the cost of goods sold to exactly zero. Without this "cap", the PURPIM "add back" would result in the cost of goods sold being a negative and a higher QPAI by the same amount.

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The Taxpayer had wages of from its own operations and from the LLC. DPAD is the lesser of of QPAI, which was , or 50% of wages, which is . The Taxpayer also had DPAD pass through from other cooperatives of . As a result, the Taxpayer computed a DPAD of for tax year .

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LAW AND ARGUMENT

The definition of a PURPIM and what entities are entitled to claim a PURPIM

The definition of a PURPIM can be found in the Internal Revenue Code's Subchapter T, which is the Subchapter for cooperative tax law. Subchapter T contains §§1381-1388, and it is I.R.C. §1388(f) that defines a Per-Unit Retain Allocation. This section states, as follows:

> "**(f) Per unit retain allocation**– For purposes of this subchapter, the term 'per-unit retain allocation' means 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 patrons.**" **(emphasis added)**

I.R.C. §1381 defines two organizations that the Subchapter applies to. These are those that fall under I.R.C. §521 (tax exempt farmers cooperatives) and corporations operating on a cooperative basis (I.R.C. §1381). The Taxpayer is a corporation operating on a cooperative basis and falls under I.R.C. §1381(a)(2). The LLC does not fall under either of these Code sections.

Thus, for an organization to be subject to the provisions of Subchapter T, it must either be a corporation operating on a cooperative basis or be subject to I.R.C. §521 (tax exempt famers cooperatives). Organizations, such as the Taxpayer, which is a corporation operating as a cooperative under I.R.C. §1381(a)(2), that are taxed under Subchapter T may allocate an amount to be paid to a patron with respect to products **marketed for him by the organization** if the amount is fixed 1) without reference to the cooperative's net earnings, and 2) pursuant to **an agreement between the organization and the patron.** See I.R.C. §1388(f). The cooperative is only allowed a deduction for the amount of the allocation that has been paid during the payment period. See I.R.C. §1382(b). **(Emphasis added)**

I.R.C. §1388(f) contains requirements that the organization be defined under Subchapter T, that the organization markets the products for the patrons, and that the agreement is between the organization and the patrons.

However, in this case, the LLC is marketing the products and the purchase agreements are between the LLC and the grain producers, some of whom are the Taxpayer's patrons. An

amount paid to a patron based on a contract between the patron and a person other than a cooperative does not meet the definition of a per-unit retain because the contract signed by the patron is not an agreement with the cooperative, as required by I.R.C. §1388(f).

We agree with Examination's conclusion that a producer, who contracts to sell his grain to a person other than a cooperative of which he is a member or participating patron, has not received a per-unit retain allocation paid in money; The patron has simply sold his grain and the payments he receives are proceeds from the sale. Further, the payor is not a cooperative and cannot issue PURPIMs. Given that the payor is not a cooperative and the seller is not its patron (within the meaning of Subchapter T) the non-cooperative purchaser can neither characterize the purchase proceeds as PURPIMs through bilateral agreement with the grain seller nor unilaterally on its own. Simply stated, an entity that is not a cooperative cannot issue PURPIMs within the meaning of Subchapter T.

Domestic Production Activities Deduction Computation

For tax years beginning in 2006, I.R.C. §199(a) allows a deduction against taxable income equal to 3% (6% for tax years beginning in 2007, 9% for tax years beginning in 2010) of the lesser of the taxpayer's qualified production activities income ("QPAI") or the taxpayer's taxable income. For this purpose, taxable income is determined without the deduction allowed by I.R.C. §199 and, in the case of a **cooperative,** without any of the deductions allowed under I.R.C. §1382(b) (relating to patronage dividends and **per-unit retain allocations paid to patrons**). See I.R.C. §199(d)(3) ***(Emphasis added)***

Treas. Reg. §1.199-1(c) defines QPAI to be an amount equal to the excess (if any) of the taxpayer's domestic production gross receipts (DPGR) over the sum of:

1. the cost of goods sold ("COGS") that is allocable to such receipts, and
2. other expenses, losses, or deductions (other than the deduction allowed under I.R.C. §199) that are properly allocable to such receipts

The deduction allowable under I.R.C. §199 is further limited in that it cannot exceed 50% of W-2 wages paid by the taxpayer during the year that are allocable to its domestic production activities. See I.R.C. §199(b).

I.R.C. §199(c)(4)(A) defines the term "domestic production gross receipts" to include the gross receipts of a taxpayer which are derived from any lease, rental, license, sale, exchange, or other disposition of qualifying production property ("QPP") which was manufactured, produced, grown, or extracted ("MPGE") by the taxpayer in whole or in significant part within the United States. I.R.C. §199(c)(4)(A)(i)(I).

Treas. Reg. §1.199-3(e)(1) provides that in general MPGE includes manufacturing, producing, growing, extracting, installing, developing, improving, and creating QPP, making QPP out of scrap, salvage, or junk material as well as from new or raw material by processing, manipulating, refining, or changing the form of an article, or by combining or assembling two or more articles; cultivating soil, raising livestock, fishing, and mining minerals.

The term MPGE also includes storage, handling, or other processing activities (other than transportation) within the United States related to the sale, exchange, or other disposition of

agricultural products, provided the products are consumed in connection with or incorporated into the MPGE of QPP, whether or not by the taxpayer. Pursuant to paragraph (f)(1) of Reg. section 1.199-3, the taxpayer must have the benefits and burdens of ownership of the QPP under Federal income tax principles during the period the MPGE activity occurs in order for gross receipts derived from the MPGE of QPP to qualify as DPGR.

Example 1of Treas. Reg. §1.199-3(e)(5) provides the following illustration of MPGE of QPP in the case of agricultural products:

> "A, B, and C are unrelated persons and are not cooperatives to which Part I of subchapter T of the Code applies. B grows agricultural products in the United States and sells them to A, who owns agricultural storage bins in the United States. A stores the agricultural products and has the benefits and burdens of ownership under Federal income tax principles of the agricultural products while they are being stored. A then sells the agricultural products to C, who processes them into refined agricultural products in the United States. The gross receipts from A's, B's, and C's activities are DPGR from the MPGE of QPP."

Treas. Reg. §1.199-4(a) requires a taxpayer to deduct from its DPGR the cost of goods sold allocable to DPGR. Treas. Reg. §1.199-4(b) requires that a taxpayer must subtract from DPGR the CGS allocable to DPGR, stating, as follows:

"A taxpayer determines its CGS allocable to DPGR in accordance with this paragraph (b) or, if applicable, paragraph (f) of this section. In the case of a sale, exchange, or other disposition of inventory, CGS is equal to beginning inventory plus purchases and production costs incurred during the taxable year and included in inventory costs, less ending inventory. **CGS is determined under the methods of accounting that the taxpayer uses to compute taxable income." (Emphasis added)**

LLC Taxable Income Computation

I.R.C. §61 states that, except as otherwise provided in Subtitle A (Income Taxes), the gross income of a taxpayer means all income from whatever source derived, including the taxpayer's distributive share of partnership gross income (I.R.C. §61(a)(13)).

I.R.C. §702(a) provides that in determining his income tax, each partner shall take into account separately his distributive share of partnership : (1) gains and losses from sales or exchanges of capital assets held for not more than 1 year, (2) gains and losses from sales or exchanges of capital assets held for more than 1 year, (3) gains and losses from sales or exchanges of property described in section 1231 (relating to certain property used in a trade or business and involuntary conversions), (4) charitable contributions (as defined in section 170(c)), (5) dividends with respect to which section 1 (h) (11) or part VII of subchapter B applies, (6) taxes, described in section 901, paid or accrued to foreign countries and to possessions of the United States, (7) other items of income, gain, loss, deduction or credit, to the extent provided by regulations prescribed by the Secretary, and (8) taxable income or loss, exclusive of items requiring separate computation under other paragraphs of this subsection.

I.R.C. §702(b) and Treas. Reg. §1.702-1(b) establish a "conduit rule" for the income taxation of partnerships, providing that the character of any item of income, gain, loss, deduction or credit included in a partner's distributive share under section 702(a) (1) through (8) shall be determined

as if such item were realized directly from the source from which realized by the partnership, or incurred in the same manner as incurred by the partnership. This section has generally been understood to mean that the partner must report his share of partnership income **as though he were the partnership so that the items retain their character when reported on his return. (emphasis added)**

The LLC taxable as a partnership for federal income tax purposes characterized the payments made for grain as purchases and includes the purchases in its calculation of its cost of goods sold for taxable income. The Taxpayer has not retained the character of the LLC's payments as purchases. The Taxpayer has re-characterized the LLC's purchases as the Taxpayer's PURPIM.

In Podell v. Commissioner, 55 T.C. 429 432-433 (1971) the tax court explained the "conduit rule" as follows:

"In essence, the "conduit rule" requires that for the purpose of determining the nature of an item of income, gain, loss, deduction, or credit in the hands of the partnership before distribution or a partner … after distribution, the partnership is to be viewed as an entity and such items are to be characterized from the viewpoint of the partnership rather than from the viewpoint of an individual partner. Thus, the phrase "his trade or business" in section 1221 (1) clearly refers to the trade or business of the partnership, despite the fact that under section 701 partnerships are not subject to income tax. It is the intent of the partnership and not that of any specific partner which is determinative in characterizing the income for purposes of taxation.

In United States v. Bayse, 410 U.S. 441 448, 93 S.Ct. 1080, 35 L.Ed.2d 412 (1973), the Court stated that:

I.R.C. §703, insofar as pertinent here, prescribes that "the taxable income of a partnership shall be computed in the same manner as in the case of an individual." See I.R.C. §703(a). Thus, while the partnership itself pays no taxes, I.R.C. §701, it must report the income it generates and such income must be calculated in largely the same manner as an individual computes his personal income. For this purpose, then, the partnership is regarded as an independently recognizable entity apart from the aggregate of its partners. Once its income is ascertained and reported, its existence may be disregarded since each partner must pay a tax on a portion of the total income as if the partnership were merely an agent or conduit through which the income passed.

In a footnote the court explained that the legislative history indicates, and the commentators agree, that partnerships are entities for purposes of calculating and filing informational returns but that they are conduits through which the taxpaying obligation passes to the individual partners in accord with their distributive shares. See, e. g., H. R. Rep. No. 1337, 83d Cong., 2d Sess., 65-66 (1954); S. Rep. No. 1622, 83d Cong., 2d Sess., 89-90 (1954); U. S. Code Cong. & Admin. News 1954, p 4017; 6 J. Mertens, Law of Federal Income Taxation § 35.01 (1968); S. Surrey & W. Warren, Federal Income Taxation 1115-1116 (1960); Jackson, Johnson, Surrey, Tenen & Warren, "The Internal Revenue Code of 1954: Partnerships", 54 Col. L. Rev. 1183 (1954).

The Seventh Circuit Court of Appeals also found in Hayden v. Commissioner, 204 F.3d 772 775 (7th Cir., 2000) that although partnerships are not subject to income tax, "[a] partnership's income, gains, losses, deductions and credits are attributable to its partners and taken into account only for purposes of determining the partner's individual income tax liabilities.

However, a partnership's income, gains, losses, deductions and credits are first computed at the partnership level before being "passed on" to its partners. That is, once these amounts are determined at the partnership level, a partnership is treated as a mere aggregate of its partners, or a conduit which serves to pass on to the partners their share of these partnership amounts…Although a partnership is not a taxable entity, section 703(a) refers to the "taxable income of a partnership" and prescribes rules for its computation…". See also Davis v, Commissioner, 74 T.C. 881, 905 (1980) (the language of 26 U.S.C 702(b) "has been consistently interpreted to mean that the character of partnership income is determined at the partnership level") and Brown Group v. Commissioner, 77 F.3d 772 (7th Cir. 2000); 96-1 USTC 50, 055 p. 83,209, (subpart F did not apply to a CFC's distributive share of gross income of a foreign partnership – "we find this analysis to be consistent with the well-established principle that income is to be characterized at the partnership level and that such income retains its character when distributed to the individual partners").

In Brown Group, supra, the court based its decision on the fact that, for the years at issue, the definition of subpart F income did not include income passed through from a foreign partnership that conducted its business in a foreign country. Therefore, the partnership income could not be subpart F income to the partners, regardless of the fact that one of the partners reporting its share of the foreign income was a controlled foreign corporation.

The LLC (taxable as a partnership for federal income tax purposes) is a separate entity and must compute its taxable income under Internal Revenue Code § 61, and the items must be passed through to the partners, retaining their character.

Cooperative Taxable Income Computation and the Treatment of PURPIM in the Computation

While Subchapter T (I.R.C. §§1381-1388) was originally enacted to apply to farmers' cooperatives exempt from income under I.R.C. §521, it also applies to any corporation that operates on a cooperative basis and allocates all or a portion of earnings to its patrons on the basis of the business done with or for such patrons. I.R.C. §1381 and Treas. Reg. §1.1381(a).

A corporation that operates on a cooperative basis but also does business with others who are not cooperative members or participating patrons is a nonexempt cooperative and the provisions of subchapter T apply only to that portion of its business that is conducted on a cooperative basis (i.e., with or for the benefit of its members/patrons). In all other respects the cooperative is taxed like any other corporation. Therefore, the cooperative must separately calculate its patronage sourced income and its nonpatronage sourced income. See Farm Service Cooperative v. Commissioner, (619 F.2d 718, 980). The cooperative's taxable income is the total of patronage sourced income and non-patronage sourced income.

Although there is no statutory definition of patronage-sourced income, Treas. Reg. §1.1382-3(c)(2) defines "income derived from sources other than patronage" (i.e., non-patronage income) to mean incidental income derived from sources not directly related to the marketing, purchasing, or service activities of the cooperative association. Guidance as to what constitutes patronage-sourced income is found in case law and in Treasury pronouncements.

A number of cases have held that where a cooperative earns income as a result of an activity that "actually facilitates" or is "directly related" to its cooperative purpose, the income is properly

characterized as patronage sourced. See Linnton Plywood Ass'n. v. United States, 410 F. Supp. 1100 (D. Or. 1976); Astoria Plywood Corporation v. United States, 79-1 U.S.T.C. P 9197 (D. Or. 1979); 1979 WL 1287, 43 A.F.T.R.2d 79-816; 79-1 USTC P. 9197; St. Louis Bank for Cooperatives v. United States, 224 Ct. Cl. 289, 624 F.2d 1041 (Cl. Ct. 1980); Land O'Lakes, Inc. v. United States, 675 F.2d 988 (8th Cir. 1982); Cotter & Company v. United States, 765 F.2d 1102 (C.A. Fed. C 1985); Illinois Grain Corporation v. Commissioner, 87 T.C. 435 (1986); Dundee Citrus Growers Association v. Commissioner, 62 T.C. Memo 1991-487M. 879 (1991); CF Industries, Inc. v. United States, 995 F.2d 101 (7th Cir. 1993).

Rev. Rul. 69-576, 1969-2 C.B. 166, provided that the classification of an item of income as either patronage or nonpatronage sourced is dependent on the relationship of the activity generating the income to the marketing, purchasing, or service activities of the cooperative. If the income is produced by a transaction that actually facilities the accomplishment of the cooperative's marketing, purchasing, or service activities, the income is from patronage sources. However, if the transaction producing the income does not actually facilitate the accomplishment of these activities but merely enhances the overall profitability of the cooperative, being merely incidental to the association's cooperative operation, the income is from nonpatronage sources.

Treas. Reg. §1.1388-1(e) defines the term "patron" to include any person with whom or for whom the cooperative association does business on a cooperative basis, whether a member or a nonmember of the cooperative association, and whether an individual, a trust, estate, partnership, company, corporation, or cooperative association.

I.R.C. §1388(a) defines a patronage dividend as an amount paid to a patron by an organization to which subchapter T applies: on the basis of quantity or value of business done with or for such patron, under an obligation of such organization to pay such amount, which obligation existed before the organization received the amount so paid, and which is determined by reference to the net earnings of the organization from business done with or for its patrons.

I.R.C. §1382(b) provides that a cooperative is permitted to reduce its patronage sourced income (but not its nonpatronage sourced income) by (among other items) the amounts paid to its patrons during the payment period:

- as patronage dividends to the extent paid in money, qualified written notices of allocation, or (with certain exceptions) other property with respect to patronage occurring during such taxable year (I.R.C. §1382(b)(1)), and
- as **per-unit retain allocations to the extent paid in money**, qualified per-unit retain certificates, or (with certain exceptions) other property, with respect to marketing occurring during such taxable year (I.R.C. §1382(b)(3)). **(emphasis added)**

I.R.C. §1382(b)(3) provides that that in determining a cooperative's taxable income, there shall not be taken into account per unit retain allocations with respect to **marketing** occurring during such taxable year. **(emphasis added)**

I.R.C. §1388(f) defines "per-unit retain allocations" to be any allocation by an organization to which subchapter T 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, and pursuant to an agreement between the organization and the patron.

The payment period for a taxable year is the period beginning with the first day of such taxable year and ending with the fifteenth day of the ninth month following the close of such year. (I.R.C. §1382(d) and Treas. Reg. §1.1382-4*)*

For purposes of reporting its taxable income, a cooperative may include its payments of per-unit retains either on Schedule A (and report it as part of its cost of goods sold on line 2 of the form 1120-C) or on Schedule H (and report it as part of its deductions and adjustments under I.R.C. §1382 on line 26a)

As mentioned previously, the LLC buys, stores, markets and sells the grain, and the LLC characterized the payments made for grain as purchases and includes the purchases in its calculation of its cost of goods sold, on its Schedule A, for taxable income. The Taxpayer did not buy, store, market or sell the grain and thus does not have the purchase of the grain on its Schedule A. The Taxpayer has not retained the character of the LLC's payments as purchases.

Partner Domestic Production Activities Computation for the LLC's activities

Treas. Reg. §1.199-3(f) provides that, in general, only one taxpayer may claim the deduction under Treas. Reg. §1.199-1(a) with respect to any qualifying activity under paragraph (e)(1), of section 199, performed in connection with the same QPP. If one taxpayer performs a qualifying activity under paragraph (e)(1) of this section pursuant to a contract with another party, then only the taxpayer that has the benefits and burdens of ownership of the QPP under Federal income tax principles during the period in which the qualifying activity occurs is treated as engaging in the qualifying activity.

With limited exceptions not relevant here, a partnership cannot calculate QPAI at the partnership level and pass the QPAI through to its partners. Rather, the partnership must separately state each partner's distributive share of the partnership's DPGR, allocable COGS, other allocable deductions, losses and expenses, and allocable W-2 wages. Each partner must then report his distributive share of such items without regard to whether allocated deductions exceed allocated gross receipts. (I.R.C. §199(d)(1)(A)(i) and (ii))

To determine his section 199 deduction for the taxable year, a partner first arrives at his QPAI by adding his distributive share of any partnership domestic production activities items (to the extent to the extent they are not otherwise disallowed by the Code) with all other such items incurred. (Treas. Reg. §1.199-5(b)(1)(i)) The applicable percentage is then applied to the lesser of the calculated QPAI or the partner's taxable income. The resulting deduction cannot exceed 50% of the partner's W-2 wages that are allocable to domestic production activities. *(IRC section 199(b))*

Losses or deductions of a partnership are taken into account in computing the partner's QPAI for a taxable year only if, and to the extent that, the partner's distributive share of those losses or deductions from all of the partnership's activities is not disallowed by I.R.C. §§465, 469, or 704(d), or any other provision of the Code. ('Treas. Reg. §1.199-5(b)(2)).

For purposes of the separate limitation under section 199(b), each partner is treated as having W-2 wages for the taxable year in an amount equal to its distributable share of the W-2 wages of the partnership that are allocable to the partnership's domestic production activities. This amount is combined with his own allocable W-2 wages (if any) before computing the limitation. (I.R.C. §199(d)(1)(A)(iii) and Treas. Reg. §1.199-5(b)(3)).

Internal Revenue Code § 199 allows a deduction for tax years beginning in 2007 equal to 6% of the lesser of QPAI (beginning in 2010 9%) or taxable income, limited to 50% of W-2 wages related to the production of qualified production property. QPAI includes income from the sale by a grain merchant of agricultural items produced in the United States that it purchased from the farmers, stored, dried, cleaned, etc. in facilities located in the United States. (Treas. Reg. §1.199-3(e)(5))

An LLC (taxable as a partnership for federal income tax purposes) engaged in the business of buying, storing and selling grain has DPGR from its grain sales if it sells grain to processors to be processed into refined agricultural products in the United States, the grain was originally produced in the United States and the partnership's storage and handling facilities are located in the United States.

Except for losses and deductions disallowed to a partner under I.R.C. §§465, 469, or 704(d), or any other provision of the Code, a partner is required to include in his calculation of his allowable deduction under IRC section 199 his distributive share of partnership DPGR and items allocable to DPGR (including COGS) passed through to him from the partnership in accordance with sections 702 and 704.

When Treasury published final regulations under I.R.C. §199, it very clearly stated that COGS must be determined under the methods of accounting that the taxpayer uses to compute its taxable income. A partnership in the business of buying and selling grain computes its COGS by adding its current inventoriable costs to the cost of its beginning inventory and subtracting the inventory on hand at the end of the year.

For federal tax purposes the income of an LLC taxable as a partnership, its relationship to its vendors, and the nature of its transactions with its vendors cannot determined under the provisions of subchapter T because the provisions of subchapter T only apply to organizations subject to IRC section 521 and to corporations operating on a cooperative basis. (I.R.C. §1381).

The Taxpayer has re-characterized the LLC's purchases as the Taxpayer's PURPIM; however, the re-characterized payments do not appear anywhere on the Taxpayer's return other than in the DPAD computation.

The Effect of Re-characterizing LLC purchases as PURPIMs

As mentioned previously, under Internal Revenue Code § 199, there is the "add-back" rule for **cooperatives**. Internal Revenue Code § 199(d)(3)(C) provides that, for purposes of Section 199, the taxable income of a specified agricultural or horticultural cooperative shall be computed without regard to any deduction allowable under section 1382 (b) or (c) (relating to patronage dividends, **per-unit retain allocations**, and nonpatronage distributions). **(emphasis added).**

Thus, the Taxpayer, by re-characterizing the LLC's purchases as PURPIM is then applying the "add-back" rule for cooperatives, and thus "adding back" the PURPIM into the DPAD computation, which affects the QPAI.

As stated in the facts, the "add-back" of the re-characterized purchases as PURPIM results in a large QPAI for the LLC activity. When the Taxpayer computed their total DPAD, they netted this large LLC QPAI against the negative QPAI (in the case of the year) or smaller

positive QPAI (in the case of the year) generated by its own operations. Since the QPAI percentage winds up being significantly larger than wages, due to the add back of the re-characterized purchases as PURPIM, and since the DPAD is the lesser of the QPAI percentage or 50% of wages, the Taxpayer receives 50% of the wages, the majority of which are, ironically, from its own operations, as DPAD.

In other words, in year , the Taxpayer would have zero DPAD from its own operations, since the QPAI is negative, and for , the Taxpayer would have had minimal DPAD from its own operations. However, due to the Taxpayer re-characterizing the LLC's purchases from the Taxpayer's patrons as the Taxpayer's PURPIM, the Taxpayer will always wind up with a large QPAI and be in the position of "maxing out" its total DPAD at 50% of wages.

ANALYSIS AND CONCLUSION

Can a LLC, which is neither a cooperative nor an agent for the Taxpayer, create a PURPIM?

The Partnership making the payment for the grain is an LLC that is being treated for tax purposes as a partnership. It is not an organization subject to Internal Revenue Code § 521 (tax exempt farmers' cooperative) nor is it a corporation operating on a cooperative basis (Internal Revenue Code § 1381). Thus, the grain purchases do not qualify as deemed per-unit retain allocations under I.R.C. §1388(f) since the LLC ("Partnership") is not an organization described in Subchapter T and the deduction is not allowable under I.R.C. §1382(b). The LLC cannot create PURPIMs.

For the purposes of Subchapter T and I.R.C. §199, can the Taxpayer re-characterize the LLC's grain purchases as PURPIMs in its DPAD computation?

The answer is no. The LLC purchased, stored, marketed and sold the grain. The agreements were between the LLC and the grain producers. The LLC's Operating Agreement clearly states that all members elected that LLC be treated as a Partnership for federal tax purposes. Partnerships do not qualify for Subchapter T status. I.R.C. §199(d) only allows for the "add back" of items allowed as deductions under I.R.C. §1382(b). Partnerships cannot take an Internal Revenue Code § 1382(b) deduction. Since the Partnership cannot create a PURPIM, the Taxpayer cannot include this item in its DPAD computation.

In conclusion, based on the facts and the applicable law, the Service concludes that Taxpayer is not entitled to take an I.R.C. §1382(b) deduction for payments made by another entity, cannot treat the LLC's purchases of grain as its own PURPIM, and cannot include this item in its DPAD computation.

For the year, the removal of the PURPIM results in a DPAD of . The Service proposes an adjustment of , a decrease to the DPAD and a resulting increase to taxable income. See Attachment 3 for the Service Recomputation.

For the year, the removal of the PURPIM results in a DPAD of . The Service proposes an adjustment of , a decrease to the DPAD and resulting increase to taxable income. See Attachment 4 for the Service Recomputation.

TAXPAYER'S POSITION is not supported by the holdings of the Private Letter Rulings

The Taxpayer does not agree to the proposed adjustment to its and DPAD disallowing the Taxpayer's treatment of the Partnership's grain purchases as PURPIM.

The Taxpayer refers to a number of Private Letter Rulings ("PLRs") in which the Service has determined that: A cooperative's payments to its patrons for purchases of grain meet the definition of per-unit retain allocations and if a cooperative transfers one or more of its functions to a partnership/LLC, to the extent that the business of the partnership/LLC furthers its cooperative aims the coop's distributive share of the entity's income from transactions with the cooperative patrons is patronage source income eligible to be allocated to the patrons under I.R.C. §1382(b). Based on these PLRs, the Taxpayer is arguing that the LLC's purchases of grain meet the definition.

The Taxpayer claims that the LLC's purchase of grain from the grain suppliers should be treated as per-unit retain allocations for purposes of I.R.C. §199 for the same reason that income from the LLC is considered to be patronage sourced, i.e., because the Taxpayer transferred its marketing function to the LLC to benefit its patrons, the LLC should be considered as having purchased the grain from the Taxpayer's patrons on the Taxpayer's behalf as though it were acting as the Taxpayer's agent.

- "Direct purchase of product by the coop is not required for the coop to be doing business on a cooperative basis and pay patronage on its distributive share of LLC income from patrons, nor should direct purchase be required for a coop to allocate proceeds to patrons through its LLC"
- "The real key to determine if the cooperative and patron have per-unit retains is if the coop is marketing product for the patron on a patronage basis. The manner of making the payment through the coop or through a 3rd party will not change the character of marketing product on a patronage basis."
- "In this case the LLC is not "allocating" a PURPIM to a partner, rather the LLC is the vehicle through which the Coop allocates a portion of the proceeds received through marketing grain on a cooperative basis."

In essence, the Taxpayer wants to re-characterize the purchases of grain made by the LLC as the Taxpayer's PURPIM.

SERVICE ANALYSIS OF TAXPAYER'S POSITION

1) The Private Letter Rulings do not support the Taxpayer's position.

Even if, in combination, the PLRs referenced by the Taxpayer supported its conclusion, the Taxpayer's reliance on the cited PLRs is misplaced. PLRs are opinions of IRS counsel attorneys

that are based on specific facts presented by the taxpayer who requested the ruling and cannot be cited in support of a taxpayer's position. However, the PLRs cited by the Taxpayer do not support the Taxpayer's conclusion. Considered together the PLRs lead only to the conclusion that:

(1) income passed through to a cooperative from a partnership whose business furthers the partner cooperative's purposes is patronage sourced to the extent derived from business done by the partnership with the cooperative's patrons

(2) the cooperative may allocate to its patrons the portion of its distributive share of the LLC net income determined to be patronage sourced based on the business that the patrons conducted with the LLC (provided that the LLC keeps records of the business done with each patron) and

(3) a <u>cooperative's</u> purchases of grain meet the definition of per-unit retains because the purchases were made by a corporation subject to Subchapter T from its patrons pursuant to an agreement (the sale contract) between the patron and the cooperative.

The Taxpayer joined in the formation of the LLC (taxable as a partnership to advance its cooperative aims by providing its patrons with a better return on sales of their grain. The LLC was expected to realize a higher net income from grain sales than was possible for the Taxpayer because the LLC would operate additional grain facilities and could purchase grain from a larger pool of farmers. The increased income would be returned, in part, to the Taxpayer (in accordance with its ownership in the LLC) and would be available for patronage distributions, provided that the LLC kept sufficient records tracking the activity with the Taxpayer's patrons. The Taxpayer's distributive share of the LLC's income from its grain operations would be considered as patronage sourced to the extent that the income was earned from the sale or warehousing of grain purchased from the Taxpayer's patrons, and the Taxpayer can distribute the income to its patrons as patronage dividends. Recall I.R.C. §1382(b) allows a **cooperative** to reduce its **patronage income** by the amount of any **patronage dividends** and per-unit retain allocations that are paid to its patrons within the payment period to the extent of its patronage income. **(Emphasis added)** The Taxpayer's income from the LLC is patronage sourced and the Taxpayer is permitted (in fact its by-laws require it) to distribute its net margins from the LLC's grain operations to its patrons as patronage dividends.

However, no part of the purchase price the LLC paid to the Taxpayer's patrons for their grain is a per-unit retain allocation. A payment to a cooperative's patron for the purchase of grain cannot be a per-unit retain allocation paid in money unless the amount is paid by an entity subject to the provisions of subchapter T and paid pursuant to an agreement between a cooperative and its patron. Since the Taxpayer was not a party to the sale contracts between its "patrons" and the LLC, the payments do not meet the definition of a per-unit retain allocation.

The Taxpayer had no ownership interest in the grain purchased by the LLC. It <u>could</u> not have purchased the grain because it had relinquished its license. It <u>did</u> not purchase the grain because the purchases were made under a contract between the LLC and the producers. The LLC owned the grain while it was stored and handled until it ultimately sold it to processors for its own profit. If the LLC did not own the grain, the LLC would not have DPGR to pass through to its partners.

The government is not arguing that the Taxpayer cannot allocate its share of the income from the LLC's grain sales to the taxpayer's patrons. Since the income is patronage sourced it may be allocated to the patrons who sold the grain to the LLC as patronage dividends. And when the patronage dividends are paid, the Taxpayer can claim a deduction under I.R.C. §1382(b)(1). It cannot, however, treat the LLC's purchases of the grain as its own purchases, treat the payments as its own allocations to its patrons, and claim that the purchases are separately deductible on its return under I.R.C. §1382(b)(3) as per-unit retain allocations paid in money.

2) The Taxpayer has not complied with the Private Letter Rulings' requirements.

Furthermore, the majority of the PLRs cited by the Taxpayer contain requirements that if a cooperative's purchases meet the definition of per-unit retains, it must treat the payments as per-unit retains for all purposes of the Code by:

1) Reporting the payments to the patrons as per-unit retains (Form 1099-PATR) and,
2) If the payments are included in Schedule A as purchases of grain, it must make adjustments to its ending grain inventory so that payments to patrons for grain that remains in its end-of-year inventory are not deducted a second time in the following year the grain is sold.

Has the Taxpayer treated the payments as per unit retains for all purposes of the Code? The answer is clearly not.

1) The Taxpayer did not issue Form 1099-PATR to its patrons.

2) The Taxpayer does not own the grain purchased from its patrons by the LLC and thus as no grain inventory so it has no way to adjust ending grain inventory to prevent double deduction of purchases as per-unit retains in one year and COGS in the year following. The LLC cannot treat the grain purchases as per-unit retains and no adjustments to its ending inventory can be made to account for the Taxpayer's treatment of the LLC's purchases as the Taxpayer's PURPIM.

3) PLR 200244013 does not support the Taxpayer's position.

The Taxpayer cites PLR 200244013 to show that the government has taken the position that a partnership's purchases from its (cooperative) partner's patrons are deemed to be the partner's purchases for purposes of § 1382. However, the PLR does not address the issue of treating partnership items as deemed payments of its partners, it addresses the patronage and nonpatronage treatment of profits derived through the partnership. The PLR concludes the coop's profits realized from its marketing activities will continue to be treated as patronage sourced income after Coop had transferred its acquisition activities to a Limited Partnership (LP) if the profits are allocated and distributed on a patronage basis to coop's members based upon the product purchased from Coop's members by LP on behalf of Coop. Coop's profits attributable to LP's product purchased from nonmembers would be taxable to the cooperative, i.e. nonpatronage-sourced income.

The PLR concerns a cooperative ("Coop") that purchased agricultural products from its members and others to be sold to others. Coop owned a substantial investment in LP whose principal

business was the purchase of the same agricultural products purchased by Coop and that purchased the majority of that product from Coop. Coop requested a ruling that if it transferred its purchasing function to LP, the profits realized from its marketing activities (now conducted through LP) would still be allocated and distributed to its patrons on a patronage basis, based on LP's purchases from the Coop's patrons.

Counsel determined that the cooperative's marketing income passed through from LP would remain patronage sourced income to the cooperative and could be paid out as patronage dividends to the extent that the cooperative and LP kept records that allowed them to allocate the marketing margins based on LP's purchases from the cooperative's members.

As stated in the PLR:

"The shift in the buying function will not alter Coop's ability to accurately allocate and pay its patronage dividends to its members and participating patrons. Coop and LP will continue to maintain all of the member and non-member purchase information that is presently maintained. Thus, the same degree of accuracy in **the computation of Coop patronage dividend** will remain."

"The Coop's profits realized from its b marketing activities **will remain patronage sourced** after Coop has transferred its b acquisition activities to LP. Coop's **profits from its b marketing activities** are to be allocated and distributed on a patronage basis to Coop's members based on the b purchased from Coop's members by LP on behalf of Coop. Coop's marketing profits attributable to LP's purchase of b from nonmembers attributable to Coop will continue to be taxable as nonmember income."

The Taxpayer points to the phrase "[product] purchased from Coop's members by LP on behalf of Coop" to substantiate its position that the patrons were actually selling the product to Coop rather than to LP and that LP's existence should be disregarded. But the turn of phrase used by a counsel attorney to explain why partnership income may be patronage sourced to the Coop does not remove the LLC and it's (cooperative) member (taxable as a partner) from the provisions of subchapter K that apply to the taxation of partnerships and partners. None of the rulings offered by the Taxpayer in support of its position leads to a conclusion that if an LLC (taxable as a partnership) operates a business which fulfills the cooperative aims of one of its members (taxable as a partner), it should be considered, contrary to I.R.C. §702(b), to be literally acting as the member or "partner's" agent.

<u>4) New PLR 201250009 does not support the Taxpayer's position</u>

PLR 201250009, which was recently issued on December 14, 2012, concluded that the partnership payments for grain could be considered PURPIM. However, it should be noted that there is a significant difference in facts between the PLR and the Taxpayer's facts in this case. The PLR states that each cooperative owner of the partnership still owns the grain elevators, has risk of loss related to the grain, and liability to the partnership for various items related to the grain. However, in the Taxpayer's case, it is the LLC (taxable as a partnership) who owns the grain elevators and has the risk of loss. The Taxpayer does not have risk of loss or any liability to the LLC other than the "typical" risk that a member ("partner") has in a partnership, of losing its capital contributions.

As to the Taxpayer's assertion that the LLC should be treated as the Taxpayer's Agent, there is no evidence of a contract naming the LLC as the Taxpayer's Agent, and there has been no evidence provided that the grain suppliers thought they were negotiating with an Agent. If the tables were turned and a patron of the Taxpayer wanted to hold the Taxpayer liable under law of agency for actions performed by the LLC, what would the patron show as proof of the agency relationship?

5) Partnership tax law does not support the Taxpayer's position

Amounts paid directly to the Taxpayer's "patrons" by the LLC were paid to purchase grain that was held as inventory by the LLC and sold for the LLC's profit. The purchases were made under contracts between the producer and the LLC, not under contracts between the producer and the Taxpayer. Since the LLC is not a cooperative taxable under the provisions of Subchapter T, its vendors cannot be the LLC's "patrons" and amounts paid to the vendors by the LLC can only be sales of grain by the vendors and purchases of grain by the LLC. They cannot be per-unit retain allocations that would be passed through to the LLC's members ("partners").

The fact that the Taxpayer has an ownership interest in the LLC and reports its distributive share of the profits from grain sales does not convert the LLC's purchases of grain from the Taxpayer's patrons into the Taxpayer's purchases from its patrons. For purposes of determining the LLC's taxable income, to be distributed to the member ("partner") cooperative (the Taxpayer), the characterization of tax items is determined at the partnership level, Internal Revenue Code § 702, on an entity basis.

The Taxpayer has no authority for re-characterizing the LLC's grain purchases (part of the COGS computation) into its own PURPIMs. The Taxpayer did not purchase the grain from its patrons for and pursuant to an agreement "between the patron and the cooperative", as specified by I.R.C. §1388, thus, the purchases are not per-unit retain allocations paid in money. The LLC is not subject to subchapter T and its purchases of grain cannot be per-unit retains. Since an LLC taxable as a partnership or a partnership cannot pass through a deduction to which it is not legally entitled, the Taxpayer is not permitted to reduce its distributive share of the LLC's COGS allocable to DPGR by the amount of the LLC's grain purchases from its patrons for purposes of I.R.C. §199.

The taxpayer's reliance on I.R.C. §752 to support its treatment of the LLC's grain purchases as per-unit retains paid to its patrons is misplaced. Subchapter K does not treat a partnership as a disregarded entity, flowing each of the transactions separately through to the partners as though the partners had signed the contracts, owned the assets and individually purchased and sold the inventory.

Although the partner is the ultimate taxpayer, applying the tax law relating to the partner's activities to the partnership (or LLC taxable as a partnership) would be contrary to the interpretation of I.R.C. §702(b) by the courts.

6) Taxpayer is bound by its chosen Form

In form, the Taxpayer has created a LLC that does not qualify for per-unit retain deductions. Regardless, the Taxpayer is bound by this form and must accept the tax consequences of their choices, whether contemplated or not. Comm. v. National Alfalfa Dehydrating & Milling Co. Supreme Court of the United States, No. 73-9, 417 US 134, 94 S.Ct. 2129, 5/28/74, the Supreme Court stated: "This court has observed repeatedly that, while a taxpayer is free to organize his affairs as he chooses, nevertheless, once having done so, he must accept the tax consequences of his choice, whether contemplated or not, and may not enjoy the benefit of some other route he might have chosen to follow but did not".

7) The Taxpayer has no legal or factual basis to characterize or re-characterize the LLC's purchases as the Taxpayer's PURPIMs.

Even when a cooperative and its patrons have the legal right to agree to characterize a transaction into a sale or a PURPIM distribution, the fact remains that transactions are either completed sales or PURPIMS, not both, based on the mutual agreement of both parties. A re-characterization from sales to PURPIMS requires evidence that both parties agreed to a re-characterization of a sale to a PURPIM. (FAA 20105101F (2010 TNT 247-13) - issued 12/23/2010).

The grain sales were between the grain suppliers and the LLC. The Taxpayer's "patrons" and the LLC did not have a meeting of the minds that their transactions were anything else but completed sales. The LLC also has no ability to enter into a PURPIM transaction since it is not a cooperative. Thus, there could be no mutual meeting of the minds that the grain purchases are PURPIM since the payor, the LLC, was not a cooperative and thus cannot re-characterize these transactions as PURPIMS.

The Taxpayer, who was not a party involved in the completed sales, has no legal or factual basis to re-characterize the LLC's completed sales into PURPIMs. A payment to a cooperative's patrons for the purchase of grain cannot be a per-unit retain allocation paid in money unless the amount is paid by an entity subject to the provisions of subchapter T and paid pursuant to an agreement between a cooperative and its patrons. The Taxpayer was not a party to the sales contracts between its patrons and the LLC. The payments do not meet the definition of per-unit retain allocation and the Taxpayer may not re-characterize the payments as PURPIM.

CONCLUSION

The facts are clear: the LLC purchased, inventoried and sold the grain; the contracts were between the LLC and the grain suppliers who are patrons of the Taxpayer; and the Operating Agreement states that all three members of the LLC elected that it be treated as a Partnership for federal tax purposes.

The Code is clear: A partnership or an LLC taxed as partnership for federal income tax purposes does not qualify for Subchapter T status; I.R.C. §199(d) only allows for the add back of items allowed as deductions under I.R.C. §1382(b); and a partnership or an LLC taxed as a partnership cannot take an I.R.C. §1382(b) deduction because it is not a cooperative or a company operating on a cooperative basis within the meaning of Subchapter K of the Internal Revenue Code.

The conclusion is clear: The Taxpayer is not entitled to take an I.R.C. §1382(b) deduction for payments made by another entity, the LLC.

The Taxpayer's position that it can re-characterize the LLC's purchases as PURPIM is based on PLRS that do not support the Taxpayer's position. The PLRs are factually different than the Taxpayer's facts, and the PLR conclusions are not the same as the Taxpayer's position. Furthermore, the Taxpayer has not considered that the transactions are either completed sales or PURPIM, but not both, and must be re-characterized by a mutual meeting of the minds, which could not occur in the Taxpayer's case, since it is not a party to the completed sales between the grain suppliers and the LLC.

Based on the facts and the applicable law, the Examiner concluded and we are of the opinion that the Taxpayer is not entitled to take an I.R.C. §1382(b) deduction for payments made by another entity, cannot re-characterize the LLC's purchases of grain as the Taxpayer's PURPIMs, cannot treat the LLCs purchases as PURPIMS, cannot exclude or remove them from COGS or otherwise add them back to its DPGI, to compute or increase the taxpayer's I.R.C. §199, DPAD.

For the year, the removal of the PURPIM results in a DPAD of . The Service proposes an adjustment of , a decrease to the DPAD and a resulting increase to taxable income. See Attachment 3 for the Service Recomputation.

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Prior to this advice being issued Senior Counsel, LB&I, RFTH (Chicago Group 2), Rogelio A. Villageliu coordinated with, and had the opinion reviewed by the Office of Chief Counsel, P&SI, Paul F. Handleman, Branch Chief and Patrick T. McGroarty, Attorney-Adviser (Tax). Please call Senior Counsel Rogelio A. Villageliu at (312) 368-8728 if you have any further questions.

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By: *__/Signed/__________________________*
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