CLIENT ALERT

IRS Extends Segregation Principle of *Farm Services Co-op* to Section 199 Deductions

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The IRS Chief Counsel's Office recently released a memorandum finding that an increase in a cooperative's section 199 deduction was patronage-based and therefore could not offset the co-op's non-patronage income. This memo follows a Chief Counsel memo released earlier this year in which the IRS took the position that a cooperative must compute separate section 199 deductions for patronage and non-patronage income.

Under *Farm Service Co-op v. Commissioner*, 619 F.2d 718 (8th Cir. 1980), a co-op may not use a deduction relating to patronage-sourced income to offset non-patronage-sourced income. In a memo released earlier this year, IRS Counsel took the position that this general principle applies to the domestic production activities deduction (DPAD) under section 199, rejecting a taxpayer's attempt to aggregate patronage and non-patronage income in its DPAD computation. In a memo released this month, IRS Counsel expanded on the application of the *Farm Service Co-op* principle to section 199, taking the position that an increase in a taxpayer's DPAD attributable to the taxpayer's reclassification of certain payments as per-unit retain allocations paid in money (PURPIMs) is inherently patronage-based, and that the increase therefore could not be used to offset non-patronage income.

I.R.C. section 199 allows a deduction for nine percent of *the lesser of* the taxpayer's qualified production activities income (QPAI) or taxable income (six percent for the year at issue in the Chief Counsel memo). The taxpayer at issue in the Chief Counsel memo, like other taxpayers prior to the enactment of section 199, had historically treated payments to members made upon delivery of goods as payments for the purchase of goods. The taxpayer, an agricultural co-op, thus included these payments in the cost of goods sold, subtracting the payment amounts from the domestic production gross receipts in calculating the QPAI for section 199 purposes.

The taxpayer then sought, and—consistent with the IRS's treatment of other taxpayers—was granted, a ruling allowing it to treat the payments as PURPIMs instead of as payments for the purchase of goods on a going-forward basis (the IRS has taken the position that the taxpayer is bound by classifications already made on prior returns). Because the Section 199 deduction for agricultural co-ops is calculated without reference to per-unit retain allocation deductions allowable under Section 1382, payments treated as PURPIMs are not included in the cost of goods sold for purposes of calculating QPAI. Treating payments to members as PURPIMs instead of as purchase payments can thus increase QPAI and the corresponding deduction.

The recent Chief Counsel memo responds to the taxpayer's request to use this type of increase in QPAI to offset non-patronage income. Although the IRS previously found that the payments could properly be classified as PURPIMs going forward, the Chief Counsel's Office here concurred in Exam's prior decision that the taxpayer could not reclassify as PURPIMs payments already classified as purchase payments. Further, the IRS found that even if the taxpayer could reclassify the payments retroactively and thereby increase its DPAD, the increase in the taxpayer's DPAD attributable to the recharacterization of the payments was inherently patronage-based. Therefore, under *Farm Service Co-Op*, the taxpayer could not use the DPAD to reduce non-patronage income. A PURPIM, the IRS explained, is inherently "paid out in the course of the cooperative's patronage business,"

and the increased DPAD could therefore "only arise from the conduct of business on a patronage basis." Therefore, the DPAD is "inherently a deduction that can only be used in the computation of patronage-sourced income." The IRS explained that all deductions figuring into a nonexempt co-op's income must separately account for patronage- and non-patronage income. Consistent with this general principle, any co-op claiming a section 199 deduction must separately compute the DPAD for patronage and non-patronage income.

The Section 199 deduction is an important tax benefit for many co-ops. In recent years, the IRS has issued a number of rulings addressing the impact of classifying payments as PURPIM on the section 199 deductions of co-ops. The recent IRS Counsel memo affirms the IRS's emphasis on separating patronage and non-patronage income, and on the application of this principle to section 199 in particular.

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David B. Blair
Partner – Washington, D.C.
Phone: +1 202.624.2765
Email: dblair@crowell.com