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Legend

Coop A =

Coop B =

b =

c =

d =

e =

f =

g =

h =

i =

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j =

Pool 1 =

Pool 2 =

Dear

This is in response to a request for rulings dated December 26, 2002, submitted on behalf of Coop A by its authorized representative.

Coop A is a farmers' marketing cooperative. Its members are some growers of *c* and *b e* located in the United States and Canada. Through a cooperative subsidiary known as Coop B, the *c* and *b e* raised by Coop A's members and nonmember patrons are processed into a number of *e*-based products, including *f* and *g*. These products are then marketed under the Coop B's brand name throughout the United States and in some 38 countries around the world.

Coop A distributes the net proceeds it receives for its *c* and *b e* to its members and to nonmember patrons on a patronage basis in the form of per-unit retain allocations (paid in cash and qualified per-unit retain certificates) and patronage dividends (paid in cash and qualified written notices of allocation).

For patronage purposes, Coop A accounts for the crop harvested each year using two pools, one for the *c* and *b e* of growers located in Pool 1 and one for the *c* and *b e* of growers located in Pool 2.

Proceeds of each pool are shared by patrons whose *e* are included in the pool based upon quantity (measured in tons), with adjustments to reflect quality and variety differences. Two adjustments are made. First, an adjustment is made to take into account the *h* content of the *e* each member delivers. *E* with higher *h* content are more desirable than those with lower *h* content, so an adjustment is made according to a formula to reflect those differences. This *h* adjustment is relaxed for *e* delivered early during the harvest. Early delivery is encouraged to spread out deliveries during the harvest to allow the receiving facilities to better accommodate the needs of all growers. Generally, the longer *e* are the higher the *h* content. Coop A relaxes *h* standards for growers who deliver their *e* early to compensate for lost time. Second, there is a varietal adjustment for *b e* (which are used in such products as *i e f*). *C* and *b e* are included in the same pool. *B e* cost somewhat more for growers to produce so all else being equal growers prefer to grow *c e*. So that sufficient *b e* are available in Pool 2 to support demand for and sales of those products, Coop A has established a varietal adjustment in the Pool 2 pool.

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The Board of Directors of Coop A (which is made up entirely of growers) establishes the *h* and *b* adjustments and monitors them carefully. The *h* differentials are intended to encourage growers to produce high quality *e* and to reward them for doing so. The early delivery adjustment is intended to encourage some growers to deliver their *e* earlier than they otherwise would if they were looking to maximize *h*. This benefits all growers by allowing the receiving stations to be operated more efficiently during the harvest. The *b* adjustment in the Pool 2 pool is designed to encourage sufficient production of *b e* to support the Coop B's line of *i e* products, which also benefits growers as a whole.

Most of Coop A's *c* and *b e* come from member growers. Coop A also markets *e* for nonmember growers. For patronage purposes, Coop A treats member and nonmember growers the same.

Coop A's patronage accounting is complicated by the fact that its crop pools generally span three fiscal years.

E are harvested in the (which with Coop A's fiscal year is the start of year). *E* are perishable, so immediately after they are harvested, they must be transported to receiving facilities where they are *f*. Some of the *f* is converted to *j*. The *f* and *j* are then placed in Part is processed and sold during the first fiscal year (the year of harvest). The remainder carries over and is processed and sold during the second year. After the close of the second fiscal year, there is a final accounting for the pool. The final pool settlement payments are made in the third year.

Pools are opened each year at the time of harvest. The newly opened pools are referred to as the "new crop" pools. A crop pool remains open until the *e* in the pool are processed and sold. In its second fiscal year, a crop pool is referred to as the "old crop" pool, to distinguish it from the newly opened "new crop" pool for the crop harvested that year.

Coop A has four pools open during the course of each fiscal year – an old crop pool in the Pool 1, a new crop pool in the Pool 1, an old crop pool in the Pool 2, and a new crop pool in the Pool 2.

Coop A does not wait until a pool is closed to make payments to growers. Coop A makes a harvest advance when *e* are delivered. The rate per ton is determined annually taking into account projected crop size, patron earnings, and cash flow needs. Thereafter, periodically over the next two years, further advances are made. The rate per ton is based on projected earnings and actual earnings to date resulting from the sale of the crop. The final distribution from each pool is normally made in January after the close of the second fiscal year.

Most pool distributions are made in cash, but a portion (which under current Coop A Board policy can be no less than 10% and no more than 30%) is made in what Coop A refers to as " " and " "

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Pool 2.

In normal year, crop yields are higher in Pool 1 than in Pool 2, resulting in a lower per-ton cost of raising e. Many years of production statistics confirm the persistence of this difference. All else being equal, in a free market, this difference, standing alone, would result in lower prices for unprocessed e in the Pool 1 than in the Pool 2.

Coop B's costs of production of finished e products have historically been higher in Pool 1 than in Pool 2.

First, labor costs have been higher in the Pool 1 than in the Pool 2 because of differences in the local labor markets.

Second, suppliers of ingredients, packaging supplies and other items to the Pool 1 production facility have historically charged more than suppliers to the Pool 2 production facilities. Pool 1 suppliers operate on a lower volume basis and thus do not enjoy the economies of scale that are available to Pool 2 suppliers. Consequently, Pool 1 suppliers generally charge more per unit.

Third, transportation costs are higher for the Pool 1 division, primarily because of the location of the Pool 1 production facility relative to its suppliers and principal markets for finished products. On average, it costs more to transport supplies from suppliers to the Pool 1 production facility than it does to do so from suppliers to the Pool 2 production facilities. Further, it costs relatively more to transport finished products from Pool 1 to the principal Pool 1 markets than it does to transport finished products from Pool 2 to the principal Pool 2 markets.

These differences are real, have been documented by the management of Coop A and Coop B's, and have been persistent. They affect the relative profitability of Coop B's Pool 1 and Pool 2 operations.

The mix of products sold by Coop B differs significantly between Pool 2 and Pool 1. This was true when Judge Hulbert first recommended two pools, and it persists today. A higher portion of Pool 2 e and up in high-margin products such g and A greater portion of the Pool 1 e end up being sold in f or being exported in j form in a market. This has a direct impact on the relative profitability of Coop B's Pool 2 and Pool 1 operations and has been documented in statistics maintained by Coop B over the years.

The provide a significant geographical barrier between markets in Pool 2 and Pool 1. Because of this barrier, e f and j do not move freely from Pool 2 to Pool 1, nor do finished e products. Transportation developments over the years have reduced that barrier somewhat, but it remains significant. That barrier results in real differences in Pool 2 and Pool 1 markets for many products, including e and e products.

Processors in Pool 1, lack scale economies because the limit the that can be economically served. In addition, as noted above, the profit

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structure of Pool 1 processors is more unfavorable because it means that they are farther from major markets and require higher freight costs to get their finished products to those markets. Packaging and ingredient costs are typically higher because suppliers also lack scale economies and are farther from the growing area and processing plants.

Ce grown in the Pool 1 are not identical to ce grown in Pool 2. There are consistent, long-standing regional differences in ce attributes. Ce grown in Pool 1 tend to have higher h , than ce grown in Pool 2. As a result, Pool 1 ce tend to command a lower price in the bulk market and to result in lower profitability in Coop B's operations.

Coop A's use of Pool 1 and Pool 2 pools is its response to these differences. Historically, in most (but not all years) Pool 1 growers have received less per ton for their ce than Pool 2 growers, which reflects the factors described above (though in terms of total proceeds received by growers this is offset in part by the higher per-acre yields in the Pool 1).

Coop A sells the ce which it receives each year from its members and nonmember patrons to Coop B pursuant to a Agreement between Coop A and Coop B. Coop B in turn processes the ce and sells the resulting products. As noted earlier, Coop B is itself organized as a cooperative, and, in the Agreement, Coop B agrees to pay Coop A for its ce an amount equal to the total net proceeds from business done with or for Coop A.

Currently, Coop A divides the net proceeds received each year from Coop B between the four pools that are open during the year using what is refers to as the "modified commercial market value" (or "modified CMV") approach. In the Coop A Cooperative Membership and Marketing Agreements with members and the corresponding Term Cooperative NonMember Patronage and Marketing Agreement with nonmember patrons), this method is described as follows:

"First, each pool shall be allocated an amount equal to the commercial market value of the crop sold during the year from the crop pool. For this purpose, a commercial market value shall be determined for each Pool 2 Division crop pool and each Pool 1 Division crop pool based upon the weighted average and h adjusted per-ton price paid producers for ce sold by pre-season contract and on the open market in the area served by the Pool 2 Division and in the area served by the Pool 1 Division, as the case may be, during the season the crop in the particular pool was delivered to Cooperative. The Board shall establish and may amend procedures for computing the commercial market value of each crop for each pool and shall establish and may amend rules and procedures for identifying which crops from which pools are sold each year.

Second, the difference (whether positive or negative) between the total net proceeds and the amount allocated to the pools based on cash commercial market value (the Coop A premium Result) shall be allocated among the pools based upon the tons of crop sold during the year from each of the pools."

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The modified commercial market value method is intended to divide the proceeds between the Pool 2 and Pool 1 pools taking into account the value differences (resulting from the factors described above) between the e in the Pool 2 and Pool 1 pools. The assumption behind the approach is that those value differences are reflected in what c e could be sold for to others in the Pool 2 and Pool 1 in an unprocessed form, i.e., in the “commercial market value” of e in the Pool 2 and Pool 1. Coop A accumulates and analyzes what other noncooperative processors pay for the new crop of c e each year. The weighted average paid in the Pool 2 is the Pool 2 CMV. The weighted average paid in the Pool 1 is the Pool 1 CMV.

Coop A has tracked the CMVs of c e in Pool 2 and in Pool 1 for many years. Typically, as a result of the factors outlined above, the Pool 2 CMV is somewhat higher than the Pool 1 CMV.

Each year, after the new crop has been harvested, and Coop A has gathered and analyzed the data, the CMVs for the new crop e in the Pool 2 pool and in the Pool 1 pool are determined. This is a mechanical determination once the data has been gathered. Once established, the CMV for a pool remains constant throughout the life of the pool. Coop A then goes through a process to divide the net proceeds it receives each year from Coop B’s among its four open pools. This pool accounting process is complicated, but is necessary to track and account for Coop A’s net proceeds on a patronage basis.

Coop A is contemplating changing how it divides proceeds each year among the four pools open during the year. Why it is contemplating making a change, what precisely that change will be and how that change will be implemented are described in turn below.

Coop A has used separate pools for Pool 2 and Pool 1 e since Pool 1 growers were first admitted to Coop A years ago. There is a broad consensus among Pool 2 and Pool 1 growers that separate pools are appropriate for the reasons described in detail above.

There has been less consensus over how precisely to divide net proceeds among the four open pools each year. For many years, Coop A used a form of direct accounting to do so, but as Coop B’s processing and marketing activities became increasingly integrated, direct accounting began to interfere with sound business and marketing decisions. Effective for the crop, Coop A began to rely upon commercial market values to divide proceeds among pools. Initially, when Coop A used this approach, it allocated the Coop A premium result among the four open pools in proportion to the commercial market values of those pools. Effective for the crop, Coop A began to use its current approach, the modified CMV approach, which divides the Coop A premium Result among the four open pools in proportion to the tons of e processed and sold during the year from each pool.

Each change was made after very careful review, with unanimous approval by the Board of Directors of Coop A (which is made up entirely of growers). The change was fully described to growers and was embodied in modifications to the Coop A Cooperative Membership and Marketing Agreement and to the Term Cooperative

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NonMember Patronage and Marketing Agreement which each grower signed.

Since the commercial market value method was adopted in _____, it has been very closely watched and scrutinized by members of Coop A, both in Pool 2 and in Pool 1. Certain perceived weaknesses of that method have drawn attention.

First, while there is a market for c e to noncooperative processor in both Pool 2 and Pool 1, that market is thin, particularly in Pool 1. This has caused many members in Pool 1 to question whether CMVs continue to be a good proxy for the value of the e in the Pool 2 and Pool 1 pools. If there were a market for e comparable in scale to the _____ members would likely have a higher level of confidence in the commercial market values.

Coop A believes that the CMV determinations are valid and representative of the value of e in Pool 2 and Pool 1. While the market is thin, information about volumes and prices at which e are sold is very good, thanks in part to _____ which requires that commercial processors publish their e prices by _____ of each year, and to the willingness of processors to share that information with Coop A after the crop has been harvested and sold on a historical basis. However, many Pool 1 members have lost confidence in the reliability of the CMVs for any year to reflect the long-term relative values of Pool 2 and Pool 1 e.

Second, commercial market values can be very sensitive to short-term imbalances between supply and demand in Pool 2 or in Pool 1. For instance, a spring freeze in Pool 2, reducing the size of the Pool 2 harvest in the _____, can lead to a spike in the Pool 2 CMV. Good weather in Pool 1, and an abundant harvest, can depress the cash market value of e in Pool 1. The prices for Coop B's products in Pool 2 and Pool 1 and Coop B's other production costs in Pool 2 and Pool 1 are not always so directly affected by such events. Many Pool 1 members are concerned that reliance on CMVs to divide pool proceeds introduces a degree of volatility that does not reflect long-term underlying differences in the value of e in Pool 2 and Pool 1. Many Pool 1 members would prefer that pool differentials be less volatile and more focused on long-term value differences.

During the past year, concerns with the use of the modified CMV approach led to a careful review of how proceeds are divided among open pools. That review was spearheaded by a committee of the Board of Directors formed in _____ 2002, and known as the CMV Study Committee. The CMV Study Committee was appointed by the President of Coop A and was made up of one Director from each of these four states: _____ The Committee was chaired by the Pool 1 Director. It pursued its review throughout 2002. Urgency was added to the Committee's review as an abnormally low harvest in the Pool 2 (as a result of a frost in the _____ Spring) and a good harvest in the Pool 1, along with other factors, led to significant differences in the CMVs for 2002 new crop e in Pool 2 and Pool 1.

The CMV Study Committee considered whether Coop A should use a single pool,

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but rejected that approach because of the continuing differences between Pool 1 and Pool 2 described above. It then considered a number of alternatives for measuring the differences in the value of e in the Pool 2 and Pool 1 pools. Its initial focus was on arriving at a formula approach for accomplishing this objective. It considered such things as a fixed differential, reexamined every five years, or a ten-year average of the CMVs in the Pool 2 and Pool 1, and ultimately rejected approaches that relied on fixed differentials and formulas. No single differential or formula held the promise of reaching a reliable result on a consistent basis. It considered a return to direct accounting, but there was concern that that method would result in constant wrangling over how to allocate revenue and expense between pools. In addition, the reason Coop A abandoned that approach years ago has not gone away - direct accounting makes it much more difficult to make sound business decisions. Rather, the Committee ultimately recommended that a process be established for determining appropriate pool differentials on an annual basis, which is not tied to formulas, but rather allows for the exercise of judgment taking into account all relevant information. This process, which will be described in detail below, is a departure from the approach used in the past, which keyed off of a single objective determination, namely the determination of CMVs.

The Committee made its recommendation to a special meeting of the Board of Directors of Coop A on . The proposal was carefully considered at that meeting. The Board did not take action at that meeting, but rather scheduled the proposal for further discussion at its next regularly scheduled meeting on . During the intervening month, there was considerable discussion and debate over the proposal, as Board members consulted with the management of Coop A and Coop B, other growers and each other. At the Board meeting, the Coop A Board of Directors adopted the new approach effective for the 2003 crop year, subject to receiving a favorable response to this ruling request.

The new approach for dividing net proceeds between pools is referred to as the "Committee Method." The Committee Method is succinctly described in the Board resolution approving its adoption:

" that except as otherwise provided below, effective with the 2003 crop and subsequent crops, the Cooperative shall allocate net proceeds among its Pool 2 and Pool 1 Division crop pools in the following manner:

- (1) The Cooperative shall first determine its net proceeds for the fiscal year from sales of all patron e without regard to crop pools (its "patron net proceeds").
- (2) The Cooperative shall then allocate its patron net proceeds for the year between the old crop and the new crop based upon tons of e sold from each crop during the year. For this purpose e sold during the year shall be accounted for on a first-in, first-out basis with the carryover old crop e treated as the first e sold each year. Carryover e at the end of a year shall be treated as proportionately coming out of Pool 2 Division crop pool and Pool 1 Division crop pool e.
- (3) The patron net proceeds allocated to the old crop shall be allocated between

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the Pool 1 Division crop pool for the old crop and the Pool 2 Division crop pool for the old crop in accordance with the Pool Differential (established as provided below) for the old crop.

(4) The patron net proceeds allocated to the new crop shall be allocated between the Pool 1 Division crop pool for the new crop and the Pool 2 Division crop pool for the new crop in accordance with the Pool Differential (established as provided below) for the new crop.

(5) A Pool Differential shall be determined each year in advance (no later than January 31) of the growing season for the crop to be harvested in the , and the Pool Differential for that crop shall remain in effect during the life of the crop pool for that crop. The procedure to be used for determining the Pool Differential each year is described in Exhibit A ("Outline of Process for Making an Annual Determination of the Pool Differential") attached hereto and made a part hereof. A new committee to be known as the Pool Differential Committee shall be established to assist in the determination of the Pool Differential. Its composition, mission and anticipated annual activities as well as an outline of factors to be taken into account in determining the Pool Differential for a crop are described in Exhibit B ("Pool Differential Committee") attached hereto and made a part hereof. It is intended that in determining the Pool Differential the principal focus will be upon the difference between the long-term value of c e in an unprocessed state raised in the Pool 1 and the long-term value of c e in an unprocessed states raised in the Pool 2. In addition Coop B's business needs, including the long-term need for an assured and adequate supply of quality e for its processing plants in the Pool 2 and Pool 1 and Coop B's business plans should be taken in account.

(6) The Pool Differential shall be expressed in dollars per ton. The patron net proceeds allocated to the old crop or new crop, as the case may be, shall be divided between the Pool 1 Division crop pool and the Pool 2 Division crop pool in such a manner that the difference between the average per-ton proceeds allocated to the Pool 2 Division crop pool and the average per-ton proceeds allocated to the Pool 1 Division crop pool equals the Pool Differential for the crop year.

(7) The method described above for allocating net proceeds between the Pool 2 and Pool 1 Division crop pools shall hereafter be referred to as the "Committee Method."

The critical difference between the Committee Method and the modified CMV method is the reliance on judgment and all relevant facts and circumstances to determine the differential between pools rather than relying on the objective determination of CMVs. In addition, the timing of determining pool differentials will change. Under the Committee Method, the differential will be determined in advance of the crop year and communicated to all members prior to the start of the growing season (when, if they

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disagree with the determination, they are still free to cancel their Agreement with Coop A and take their e elsewhere). Under the modified CMV method, CMVs are determined after the harvest when information is available to make the objective determination. In addition, to make the Committee Method workable, the assumption will be made that the carryover inventory at the end of each year comes proportionately out of the new crops in the Pool 2 and Pool 1. Under the current approach, there is a separate tracking of e inventories and their usage in the Pool 2 and Pool 1.

Because the new approach makes determination of the pool differential each year a matter of judgment, the process was carefully designed to encourage the development of consensus between Pool 2 and Pool 1 and to assure that the judgment would be exercised properly and on a timely basis. That process is described in materials attached as Exhibit A to the Board resolution:

“I. Coop A management (with the assistance of Coop B) makes a recommendation of the pool differential for the upcoming crop (the “Coop A Recommendation”). This recommendation is then forwarded to the Pool Differential Committee.

The Coop A recommendation shall include the following:

(a) An item by item list of the factors considered by management to be relevant with respect to the year for which the pool differential is being determined.

(b) Each line item shall have a pool differential value assigned to it.

(c) Each line item shall be weighted with a percentage value relative to the importance of that particular line item. The sum of all weighting percentages shall be 100%.

(d) A written narrative maybe included describing the reasons why management feels the line item assignments of differential value and weighting percentages is appropriate.

(e) The recommendation including line item list and narrative shall be kept for future reference to improve consistency from year to year and to assist further management teams.

II. The Pool Differential Committee:

(a) accepts the Coop A Recommendation, making it its own recommendation,

(b) comes up with its own consensus recommendation, or

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(c) does neither, and deadlocks.

The Pool Differential Committee's recommendation, if there is one, (II (a) or II (b)), is then forwarded to the Coop A Board. If the Pool Differential Committee is unable to reach a consensus (II (c)), it then forwards the Coop A Recommendation to the Coop A Board.

III. The Coop A Board either:

(a) accepts the Pool Differential Committee recommendation (in situations II (a) or II (b)) or the Coop A Recommendation (in situation II (c)), in which case the process is over and the pool differential is set for the upcoming crop, or

(b) rejects the Pool Differential Committee recommendation (in situations II (a) or (b)) or the Coop A Recommendation (in situation II(c)), in which case the matter goes to binding arbitration.

The Coop A Board cannot itself determine the differential; it is limited to taking the actions described above.

IV. The Arbitrator.

The Coop A Board shall select the Arbitrator annually not later than the May Board meeting from a slate of 3 candidates presented by Coop A management. In the event of III(b), the matter goes to Binding Arbitration: the arbitrator must choose from three alternatives:

(i) the Pool Differential Committee recommendation (in situations II (a) or (b)) or the Coop A Recommendation (in situation II(c)),

(ii) a differential recommended by a caucus of the Pool 2 Directors (the "Pool 2 Recommendation"), or

(iii) a differential recommended by a caucus of Pool 1 Directors (the "Pool 1 Recommendation").

The decision of the arbitrator, which shall be made no later than January 31, is final and establishes the differential for the upcoming crop."

The proposed approach intentionally does not permit the Board of Directors of Coop A to make its own determination of the differential. The Board can either approve or reject the Committee Recommendation or, if the Committee has not reached a consensus, the Coop A Recommendation. Coop A has many more growers in Pool 2 than in Pool 1. Coop A is organized on a one-member, one-vote basis. Coop A's Board composition reflects the composition of its membership. As a consequence, a majority of the directors are from Pool 2. Given this fact, it was decided

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not to give the Board the latitude of coming up with its own differential.

The Pool Differential Committee is described in detail in Exhibit B attached to the Board resolution, which states:

“ _____

The Pool Differential Committee (the “Committee”) shall consist of four persons, two of whom shall be Pool 2 grower members of Coop A and two of whom shall be Pool 1 grower members of Coop A. Coop A’s President, with the advice of the Coop A Board, shall appoint the members of the Committee.

When the Committee is first formed, one of the initial Pool 2 members and one of the initial Pool 1 members shall be appointed for one-year terms. The other Pool 2 member and Pool 1 member shall be appointed for two-year terms. Each Coop A’s President shall appoint members to replace those whose terms are expiring (or may reappoint a member or member whose term is expiring for an additional term), and subsequent appointees shall serve for a two-year term. A member of the Committee shall be eligible for reappointment for an additional term or terms when his or her term expires.

The purpose of the Committee shall be to make a recommendation each year in _____ to the Board of Directors of Coop A as to the dollar amount of the differential for the crop to be raised in the succeeding year to be used by Coop A in apportioning net proceeds received from Coop B between the Pool 2 pool and the Pool 1 pool. This differential shall be referred to as the “Pool Differential.”

thCoshould consider in determining the Pool Differential.

It is intended that in determining the Pool Differential for a year, the principal focus of the Committee will be upon the difference between the long-term value of c e in an unprocessed state raised in the Pool 1 and the long-term value of c e in an unprocessed state raised in the Pool 2. In addition, the Committee may take into account Coop B’s business needs, including the long-term need for an assured and adequate supply of quality c e for its processing plants in the Pool 1 and Pool 2 and Coop B’s business plans. The Pool Differential is intended to reflect the differences in long-term value of e, with such modifications as may be required to serve the business needs of Coop B’s.

In its deliberations, the Committee may take into consideration the following factors:

- most recent CMV in the Pool 2 and the Pool 1;
- rolling, historical CMV data;
- historical direct accounting data;

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- industrial bulk pricing;
- industry inventory data (supply and demand);
- Coop B's long-term requirements in the Pool 2 and Pool 1;
- crop yield and quality;
- any other data the Committee deems relevant to determine the long-term value of c e in the Pool 2 and Pool 1;
- transportation costs;
- crop allocations by commercial processors.

The Pool Differential is not intended to be a forecast of the differential that is anticipated to be present in the market when the crops of the succeeding year are harvested. Rather it is intended to reflect longer-term differences. Accordingly, the above list of factors which the Committee may consider is not intended to be a comprehensive, exhaustive list of factors or data which the Committee may deem relevant to its annual deliberations, rather the above list is included to illustrate the kind of data which the Committee may include in its determination of the annual Pool Differential.

In each year, the President, with the advice of the Board, shall appoint the members of the Committee to replace those whose terms are expiring (or reappoint a member or member whose term is expiring for another term). Appointments shall be announced along with the appointments for other committees.

No later than each year, Coop A management (with the assistance of Coop B's management) shall make a recommendation (the Coop A Recommendation) to the Committee. The Coop A Recommendation shall include a recommended Pool Differential for the upcoming year and the basis for that recommendation.

Thereafter, the Committee shall meet and deliberate. The management of Coop A and Coop B shall provide the Committee with such assistance as it may require, including help in gathering and analyzing any data and information that the Committee may regard as helpful in its deliberations. The Committee shall then either (i) accept the Coop A recommendation, making it its own recommendation, or (ii) come up with its own recommendation.

The Committee shall make its recommendation (the Committee recommendation) to the Board of Directors of Coop A at its regularly scheduled meeting. That recommendation shall include a recommended Pool Differential for the upcoming year and the basis for that recommendation. If the Committee is unable to reach agreement as to a recommendation for the Pool Differential, it shall so inform the Coop A Board at that meeting.

The intent of this method is to allow the Pool Differential Committee to exercise its judgment in determining the pool differential. Choice of this approach is a rejection of an

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approach that is formula driven.

As described above, the new method was developed after careful study by a special committee of the Board of Directors of Coop A. It was reviewed and debated at a special meeting of the Board of Directors of Coop A. It was adopted at the meeting of the Board of Directors of Coop A effective for the 2003 crop year (subject to obtaining a favorable response to this ruling request). There was considerable discussion of the Committee Method during the period between the two Board meetings as Directors discussed the proposal among themselves and with the management of Coop B and Coop A.

A Pool Differential Committee has been appointed, and the process is underway to determine the pool differential for the 2003 crop. The new method will be embodied in an amended and restated Cooperative Membership and Marketing Agreement and Term Cooperative NonMember Patronage and Marketing Agreement, and all members and nonmember patrons of Coop A will be asked to enter into the applicable revised Agreement (once a favorable response is obtained to this ruling request) effective on a prospective basis for the 2003 crop. By the time members and nonmember patrons are asked to sign new Agreements, the pool differential for the 2003 crop will have been determined and communicated to Coop A's growers.

If the process of presenting new Agreements to growers does not occur prior to (the automatic renewal date for existing Cooperative Membership and Marketing Agreements), growers who opt not to sign a new Agreement will be permitted to deliver their 2003 crop under the terms of their existing Agreement. However, they will not be permitted to renew their old Agreement thereafter. In the transition year, proceeds will be allocated to the 2002 crop pools in accordance with the existing modified CMV approach as called for in the existing Agreements.

Based on the foregoing, Coop A requests the following rulings:

The "Committee Method" described above is, (i) a permissible approach under subchapter T for dividing proceeds each year among Coop A's open crop pools, (ii) consistent with "operating on a cooperative basis" as that term is used in sections 521(b)(1) and 1381(a)(2) of the Code, and (iii) consistent with the principle of "equitable allocation" enunciated in Rev. Ruls. 72-547 and 74-567, provided:

(a) it is approved by the Board of Directors of Coop A (which consists entirely of grower-members of Coop A elected on a one-member, one-vote basis);

(b) it is embodied in a revised Coop A Cooperative Membership and Marketing Agreement and Term Cooperative NonMember Patronage and Marketing Agreement, which each continuing member and nonmember patron of Coop A enters into with Coop A;

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(c) it is adopted prospectively to apply to the 2003 crop (and not to the 2002 crop);

(d) the procedures for making the annual pool differential determination outlined in the Board Resolution and attached exhibits remain in effect and are followed each year;

(e) the pool differential for the crop to be harvested in the fall is determined each year in advance of the opt-out period for members and nonmember patrons under the Coop A Agreements (i.e., before the month of) and is communicated to members and nonmember patrons; and

(f) members and nonmember patrons continue to have the opportunity to terminate their Coop A Agreements during the opt-out period in the event they do not agree with the pool differential determination for the upcoming crop year and wish to sell their e elsewhere.

Compliance with the conditions set forth above is subject to confirmation upon audit.

Pursuant to the provisions of Subchapter T (Sections 1381 - 1388) of the Code, cooperatives are permitted to exclude from income amounts paid to their patrons as per-unit retain allocations and as patronage dividends. Sections 1382(b)(2) and (3). Section 1388(f) defines “per-unit retain allocation” as “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.” Section 1388(a) defines “patronage dividend” as:

“... an amount paid to a patronage by an organization to which part I of this subchapter applies –

(1) on the basis of quantity or value of business done with or for such patron,

(2) under an obligation of such organization to pay such amount, which obligation existed before the organization received the amount so paid, and

(3) which is determined by reference to the net earnings of the organization from business done with or for its patrons.

Such term does not include any amount paid to a patron to the extent that (A) such amount is out of earnings other than from business done with or for patrons, or (B) such amount is out of earnings from business done with or for other patrons to whom no amounts are paid, or to whom smaller amounts are paid, with respect to substantially identical transactions.

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Subchapter T contemplates that marketing cooperatives may use pools. Pools are specifically mentioned in Subchapter T. See for example, Sections 1382(e), which provides technical rules so that payments with respect to a pool qualify as either per-unit retain allocations or patronage dividends. See also, Section 1382(g). Subchapter T provides for per-unit retain allocations to make pooling possible. After Subchapter T was enacted in 1961, Congress revisited Subchapter T on two occasions (in 1966 and 1969) to adjust the rules with respect to per-unit retain allocations so that they worked properly.

Rev. Rul. 67-333, 1967-2 C.B. 299, illustrates the applicability of the rules of Subchapter T to cooperatives that pool. Advances and payments made to patrons while a pool is open are treated as per-unit retain allocations. The final payment in settlement of a pool is treated as a patronage dividend.

Subchapter T does not provide further guidance with respect to pools. There are no specific provisions setting rules for the composition of pools or allocation units to be used by cooperatives, other than a parenthetical in Section 1388(j)(1) recognizing that allocation units may be “functional, divisional, departmental, geographic, or otherwise.”

In judging the appropriateness of allocation methods, the courts have looked closely at the process used to approve the allocation practice in question. If that process was open, the decision was made by representatives of the members, and communicated to the members, then the Courts have deferred to the judgment of the cooperative and its membership. See e.g., *Pomeroy Cooperative Grain Company v. Commissioner*, 288 F2d 326 (8th Cir. 1961); *Juniata Farmers Cooperative Association*, 43 TC 836 (1965), acq.; *Associated Milk Producers, Inc.*, 68 TC 729 (1977); *Ford-Iroquis FS, Inc.* 74 TC 1213 (1980); *Lamesa Cooperative Gin*, 78 TC 894 (1982); *Kingfisher Cooperative Elevator Association*, 84 TC 600 (1985).

In Rev. Rul. 63-58, 1963-1 C.B. 109, the Internal Revenue Service announced that it would follow the decision of the Eighth Circuit Court of Appeals in *Pomeroy*. That decision permitted a cooperative to combine its grain and storage activities into a single unit for patronage dividend purposes. The Court in *Pomeroy* had observed:

“From a revenue standpoint, the Commissioner should be more concerned with the total exclusions allowable on membership business profits rather than the means by which such profits are divided among the qualified members.”

In Rev. Rul. 72-547, 1972-2 C.B. 511, the Internal Revenue Service considered a local grain elevator which combined grain marketing and feed activities into a single allocation unit and paid patronage both to farmers who delivered grain to the unit for marketing and to farmers who bought grain from the unit for feed. The cooperative proposed using a “bushel-in, bushel-out method” to allocate earnings from the unit (which essentially split the profits of the unit between the farmers marketing grain through the unit and the farmers buying grain for feed from the unit). The Service left it to the judgment of the cooperative what to pay farmers for their grain and to charge

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farmers for feed. In approving use of that method, the ruling observed that it “comports with the cooperative principle of ‘equitable allocation.’”

In Rev. Rul. 74-567, 1974-2 C.B. 174, the Service permitted a grain cooperative, which had a soybean processing branch and a grain elevator branch, to establish a third branch described as a “feed yard branch.” Members who helped finance the feed yard branch were permitted to sell their grain directly to that branch. The remaining grain and soybean needs of the feed yard branch were met with grain and soybeans supplied by the other two branches. The Service ruled that the cooperative could establish a separate feed yard branch and approved the practice of allowing members who helped finance the feed yard to sell their grain directly to the feed yard unit:

“In the instant case, while the total patronage dividend received by the patrons may differ in amount with respect to the marketing of identical products through different branches, the equality of treatment principle is not violated. The feed yard branch is a separate allocation unit. The earnings and losses of the feed yard branch, as with the other units, are attributable to the patrons of that unit in proportion to the quantity or value of business done with that unit. The members of the cooperative chose to establish a separate feed yard branch. While direct participation in the feed yard branch is limited to those patrons whose capital financed the operation, its establishment as a separate allocation unit does not violate the principle of ‘equitable allocation.’ See, Rev. Rul. 72-547, 1972-2 C.B. 511. Since all patrons within each of the allocation units are treated equally the equality of treatment principle reflected in section 1388 of the Code is not violated.”

The cases and rulings described above identify a number of factors that should be considered in evaluating an allocation process employed by a cooperative. The key factors are as follows:

1. Who designed the process? Was there opportunity for member input from all categories of affected members?
2. Who approved the process? If it was approved by the Board of Directors, are the Directors all members? Are they chosen on a one-member, one-vote basis?
3. Was the process submitted to members for their approval by a vote or otherwise? Did the process require an amendment or change to the members’ individual marketing agreements, requiring each member’s approval?
4. Were members clearly informed of the new process and its consequences?

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5. Was the process adopted to apply prospectively?
6. Does the process protect the interests of patrons who do not vote (i.e., nonmember patrons)?
7. Does the process protect the interests of classes or categories of members who are minorities (who could be outvoted by other members when voting is done on a one-member, one-vote basis)?
8. If the process involves the exercise of discretion, is the discretion required to be exercised (and the results communicated to members) before members patronize the cooperative?
9. If members do not like the results of the process, can they terminate their marketing agreements and go elsewhere, or are they bound by their marketing agreements to continue to do business with the cooperative?
10. If the process self-correcting? If members do not like the results of the process, but elect to remain with the cooperative, can they influence the process in the future through their power to elect new Directors?

The next section of this ruling will analyze the change being proposed by Coop A.

The proposed changes will affect the division of the net proceeds that Coop A receives each year from Coop B's among the four pools that are open during the year. Both before and after the change net proceeds will be shared among the pools based on relative value. Before the change, the determination of relative value depended solely on an objective determination, namely the determination of commercial market values. After the change, the determination of relative value will be made through a process which relies on judgment and is free to consider all relevant information.

The change is being made to reach a result that better reflects the long-term differences between the values of e in the Pool 2 $c e$ and Pool 1 $c e$ pools. Coop A's current approach relies solely upon the commercial market values of e in the Pool 2 and Pool 1 under the assumption that CMVs provide a good proxy for relative values. Because of the increasing thinness of the markets for $c e$ and because of the volatility of those markets, many growers would like Coop A to try a different approach. After much consideration, it was decided that the best alternative is to set up a process for annual determinations of the pool differential for the upcoming crop based upon the exercise of judgment taking into account all relevant information.

The proposed changes are the result of careful study and consideration by a special committee of the Board of Directors of Coop A (assisted by the management of Coop A, the management of Coop B and outside advisors). The changes were considered and approved by the Board of Directors of Coop A with broad support from

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Directors from both Pool 1 and Pool 2.

Coop A is organized on a one-member, one-vote basis. All of its Directors are grower members. The composition of the Board of Directors reflects the composition of its membership. As noted above, there was a one-month period between the time the changes were discussed initially at a special Board meeting and then approved at the regularly scheduled Board meeting. This one-month period allowed the Directors to further deliberate and discuss the proposal, to assess its impact on the membership.

Many of the case and rulings discussed above talk about how the allocation practice in question was used with the “apparent” knowledge and approval of the membership. Because the method of dividing proceeds among pools is embodied in Coop A’s Agreements with growers, Coop A will have more than “apparent” knowledge and approval – Coop A will be obtaining the actual approval of each member and nonmember patron.

The changes will be embodied in a revised Cooperative Membership and Marketing Agreement and in a revised Term Cooperative NonMember Patronage and Marketing Agreement, which will be given to each member and nonmember patron of Coop A. Assuming a favorable response to this ruling request, members and nonmember patrons will be asked to enter into a new Agreement, embodying the changes, to be effective with the 2003 crop. As noted above, growers will know the pool differential for the 2003 crop by the time they are asked to enter into the new Agreement. Depending upon whether there is unanimous acceptance by Coop A’s members and nonmember patrons, Coop A’s fiscal year ended 2004 or 2005 will be the transition year, with the new method applicable to the new crop pools and the old method applicable to the old crop pools. Thereafter the new method will be fully implemented.

To provide a starting point each year, the management of Coop A will make a recommendation as to what it believes is the appropriate pool differential for the coming year and the reasons for recommending that differential. Management of Coop A is perceived by growers in both the Pool 2 and Pool 1 as neutral and acting in the best interests of the membership of Coop A as a whole.

The Pool Differential Committee (which is made up of two Pool 2 and two Pool 1 growers) can accept the recommendation of Coop A’s management or come up with its own recommendation. It is empowered to consider all facts that it believes relevant and management of Coop A and Coop B is directed to provide the Committee with such support and assistance as it requires to do its task. Pool 1 growers are given equal representation on the Pool Differential Committee even though they constitute a minority of the Coop A growers to assure that they will not be disadvantaged in this process.

The pool Differential Committee will then forward its recommendation (or the Coop A recommendation if the committee deadlocks) to the board of Directors of Coop A. The Board can either accept or reject the recommendation forwarded to it. The

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Board can not make an independent determination of the differential. This limitation on what the Board can do is intended to protect Pool 1 growers whose Directors constitute a minority of the members of the Board.

If the Board of Directors rejects the recommendation, an arbitrator will make the final decision, employing “baseball-style” arbitration. The arbitrator must choose between three alternatives: (i) the recommendation that was forwarded to the Board (which is either the Pool Differential Committee recommendation or the Coop A recommendation), (ii) a differential recommended by a caucus of Pool 1 Directors (which would meet to make this recommendation after the Board acted to reject the recommendation), and (iii) a differential recommended by a caucus of Pool 2 Directors (which would also meet to make the recommendation after the Board acted). Baseball-style arbitration was chosen for several reasons. First, it is felt that this kind of arbitration encourages participants to be more reasonable in their positions. Since the arbitrator can not simply split the difference, if a party espouses an extreme position, that party risks having the arbitrator reject its position. Second, baseball-style arbitration does not allow the arbitrator to totally supplant the judgment of the members of the cooperative by arriving at a differential no one recommended.

The process does not build in any special protection for nonmember patrons since Coop A is a section 521 cooperative. The rules of section 521, which require Coop A to treat members and nonmembers alike, already provide the necessary protection for nonmembers.

The timetable for making the pool differential decisions is such that the pool differential for the upcoming year will be determined and communicated to members during each year. This will allow a member who is not happy with the differential to terminate his or her Coop A Cooperative Membership and Marketing Agreement. Coop A’s agreements with members are for an initial term of one year. Thereafter, they can be terminated by either Coop A or the member by giving notice during

Equally important, for those growers who remain, the pool differential will be known and fixed. While the determination of the pool differential relies upon judgment and provides for discretion, that discretion must be exercised and the determination must be made in advance of the growing season. Thus, there is no question what Coop A’s pre-existing obligation will be with respect to its pools.

Coop A is organized on a one-member, one-vote basis. Its Board is made up entirely of growers. The Pool Differential Committee will be made up entirely of growers.

Should the Committee Method produce a result that the membership finds unacceptable, there are many checks and balances built into the system that will assure that the Committee Method gets back on track:

- Members can and do express their views to Directors, who are their friends, neighbors and fellow-growers.

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- Directors are very sensitive to the views of members. Unhappy members can and do replace directors that are perceived as not representing their interests.
- Truly unhappy members will be able to leave Coop A by terminating their Coop A Membership and Marketing Agreements and taking their e elsewhere.
- If the Committee Method does not for some reason work, the Board retains the authority to change the method prospectively going through the same process that led to the adoption of the method.

The cases and ruling note some other miscellaneous factors when evaluating patronage practices. Some explore whether membership of the cooperative is stable. Coop A's membership is very stable. Of Coop A's approximately members, on average roughly 5 to 10 members leave each year, with approximately half of the departing members leaving due to retirement. The retiring members are often succeeded by other family members of relatives who become new members. Others look to whether the cooperative is democratically controlled. As noted above, Coop A is organized on a one-member, one-vote basis. All of its Directors are growers. Others look to whether a practice has been imposed upon a group of patrons (i.e., nonmembers) that have no voice in the affairs of the cooperative. That is not the case here. The changes affect members and nonmembers alike. Both Pool 2 and Pool 1 growers were involved in the process of developing and adopting the new approach. The process for deciding upon the pool differential each year has been designed to give the minority Pool 1 growers an equal voice in the process.

The process was designed by a special committee of Coop A Directors with substantial input from other Directors, members, the managements of Coop A and Coop B and outside advisors. Pool 2 and Pool 1 growers were jointly involved in the process.

The process was approved by the Board of Directors of Coop A with substantial support by both Pool 1 and Pool 2 Directors. All of the Directors are members. They are elected on a one-member, one-vote basis.

Implementing the Committee Method will require a change to the Coop A Cooperative Membership and Marketing Agreement and the Term Cooperative NonMember Patronage and Marketing Agreement so all members and nonmembers patrons will be required to individually approve the method.

As part of the process of getting agreement of each member and nonmember patron to a new Agreement, each member and nonmember patron will be informed of the new process and its consequences. When the member is asked to sign the new agreement, the member and nonmember patron will know the pool differential for the first year.

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The Committee Method will be applied prospectively to the crop to be harvested in the _____ of 2003. The existing approach will continue to be applied to the 2002 pools.

Coop A is a section 521 cooperative. As a result, it treats all member and nonmember patrons alike. Consequently, no additional safeguards are required to protect the interests of nonmembers.

As described in detail above, the process has been carefully designed to protect the interests of Pool 1 growers who constitute a minority of the Coop A growers. Pool 1 growers are given equal representation on the Pool Differential Committee. The board of Directors (where Pool 2 Directors outnumber Pool 1 Directors) is not permitted to make an independent determination of the pool differential if it disagrees with the Committee recommendation or the Coop A recommendation. The pool differential for a year must be determined by the end of _____ will in advance of the growing season and harvest. Members and nonmember patrons of Coop A have the option of terminating their Agreement each year during the month of _____. If they are not satisfied with the determination of the pool differential for the upcoming year, they are free to terminate their marketing agreements and to take their crop elsewhere. The process is self-correcting. If members do not like the result, they can convey their views to the existing Directors. If corrections are not made, they can replace existing Directors.

Based on the foregoing, we rule that:

The "Committee Method" described above is (i) a permissible approach under subchapter T for dividing proceeds each year among Coop A's open crop pools, (ii) consistent with "operating on a cooperative basis" as that term is used in sections 521(b)(1) and 1381(a)(2) of the Code, and (iii) consistent with the principle of "equitable allocation" enunciated in Rev. Ruls. 72-547 and 74-567, provided:

(a) it is approved by the Board of Directors of Coop A (which consists entirely of grower-members of Coop A elected on a one-member, one-vote basis);

(b) it is embodied in a revised Coop A Cooperative Membership and Marketing Agreement and Term Cooperative nonmember Patronage and Marketing Agreement, which each continuing member and nonmember patron of Coop A enters into with Coop A;

(c) it is adopted prospectively to apply to the 2003 crop (and not to the 2002 crop);

(d) the procedures for making the annual pool differential determination outlined in the Board Resolution and attached exhibits remain in effect and are followed each year;

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(e) the pool differential for the crop to be harvested in the fall is determined each year in advance of the opt-out period for members and nonmember patrons under the Coop A Agreements (i.e., before the month of) and is communicated to members and nonmember patrons; and

(f) members and nonmember patrons continue to have the opportunity to terminate their Coop A Agreements during the opt-out period in the event they do not agree with the pool differential determination for the upcoming crop year and wish to sell their e elsewhere.

Compliance with the conditions set forth above is subject to confirmation upon audit.

This ruling is directed only to the taxpayer that requested it. Section 6110(k) provides that it may not be used or cited as precedent. In accordance with a power of attorney on file in this office, a copy of this ruling is being sent to your authorized representative.

Sincerely yours,

Walter H. Woo
Senior Technician Reviewer
Branch 5
Office of Associate Chief Counsel
(Passthroughs & Special Industries)

cc: