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NATIONAL COUNCIL OF FARMER COOPERATIVES

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August 31, 2005

Attn: Comments on the "Tax Technical Corrections Act of 2005"
United States Senate
Committee on Finance
219 Dirksen Senate Office Building
Washington, D.C. 20510-6200

Dear Senator Grassley and Senator Baucus:

The National Council of Farmer Cooperatives (NCFC) respectfully submits the following comments on S. 1447, the Tax Technical Corrections Act of 2005 (the Act). NCFC would like to commend you for your leadership on the passage of the "American Jobs Creation Act" (AJCA). We believe the new Internal Revenue Code Section 199 deduction for qualified production activities income, created by the AJCA, will spur economic growth and will help farmer cooperatives and their members realize greater income potential.

Farmer cooperatives provide over 300,000 jobs in the United States, with a total payroll in excess of $8 billion, and contribute significantly to the economic well-being of rural America. Since 1929, NCFC has been the voice of America's farmer cooperatives. Our members are regional and national farmer cooperatives, which are in turn comprised of more than 3,000 local farmer cooperatives across the country.

Our comments address several issues relating to the implementation of the Section 199 deduction.

Clarify Language Regarding Denial of Deduction for Portion of Qualified Payments. The Act proposes the language of Code Section 199(d)(3)(B) as follows:

> "(B) COOPERATIVE DENIED DEDUCTION FOR PORTION OF QUALIFIED PAYMENTS. -- The taxable income of a specified agricultural or horticultural cooperative shall not be reduced under section 1382 by reason of that portion of any qualified payment as does not exceed the deduction allowable under subparagraph (A) with respect to such payment."

Our understanding of the meaning and purpose of the language is illustrated by the following example:

> Assume a "specified agricultural or horticultural cooperative" has net earnings of $1 million for its fiscal year ended September 30, 2006, from marketing the agricultural or horticultural products of its members. All of the net earnings are qualified production activities income by reason of Section 199(d)(3)(D). The cooperative markets its members' products on a buy/sell rather than a pooling basis.
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> On December 15, 2006, the cooperative pays a patronage dividend of $1 million to its members and notifies its members that it is passing through $30,000 of Section 199 deductions. Patron A, whose products account for 1 percent of the products marketed by the cooperative for the year, receives a $10,000 patronage dividend and is notified that $300 of Section 199 deductions has been passed through to him or her.
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> In this example, it is our understanding that the "qualified payment" (i.e., the portion of the patronage dividend "attributable to qualified production activities income with respect to which a deduction is allowed to such cooperative under subsection (a)") is $30,000. In this case, since the cooperative passed through the full amount of its Section 199(a) deduction for the year, the "portion of any qualified payment as does not exceed the deduction allowable under subparagraph (A) with respect to such payment" is also $30,000. This language refers to the deduction allowable to members of the cooperative and the members as a group are entitled to deduct $30,000 under Section 199(a).
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> Under Section 199(d)(3)(B), the cooperative is entitled to claim a patronage dividend deduction of $970,000 (i.e., its patronage dividend reduced by the amount of Section 199 deduction passed through) and to claim a Section 199 deduction of $30,000 on its 9/30/2006 return. The members (assuming that they are all calendar year taxpayers) are required to include $1,000,000 of patronage dividends in income and are entitled to deduct $30,000 under Section 199(a) on their 2006 income tax returns.

Absent any special language in Section 199, the cooperative in the example would have been entitled to both a Section 1382 patronage dividend deduction of $1 million and a Section 199(a) deduction of $30,000. The language of Section 199(d)(3)(B) is obviously intended to prevent both the cooperative and its members from claiming the benefit of the portion of the Section 199(a) deduction passed through.

However, the approach taken in the Technical Correction, namely reducing the cooperative's patronage dividend deduction, while allowing both the cooperative and its members to claim a Section 199 deduction in the amount of $30,000, is counter-intuitive. We are concerned that the IRS might some day argue that <u>both</u> the cooperative's patronage dividend deduction and its Section 199(a) deduction should be reduced by the amount passed through, a clearly incorrect

result. There is no clear statement in the Technical Correction that the cooperative remains entitled to the full Section 199(a) deduction.

We assume that the language was drafted as it was in order to leave the cooperative (and not the members) accountable if it is later determined on audit that the proper amount of the Section 199 deduction for the year was less than $30,000. We do not disagree with that approach to treating audit adjustments.

At a minimum, we suggest that an explanation (and perhaps an example) should be set forth in any committee report that accompanies the Tax Technical Corrections Act of 2005 so that the language of Section 199(d)(3)(B) will not later be misconstrued.

We also question why the phrase "as does not exceed" is used in this section instead of simply stating that the patronage dividend will be reduced by an amount "equal" to the Section 199(a) deduction passed through. Are there instances where the adjustment to the patronage dividend can be less than the amount of the Section 199(a) deduction passed through? The language seems to suggest that might be the case.

Clarify Timing of the Deduction. The statutory language as proposed in the Act (Code Section 199(d)(3)(A)) provides that any person who receives a Section 199 "qualified payment" from an agricultural or horticultural cooperative will be allowed a deduction "for the taxable year in which such payment is received" so long as the amount is "identified by such cooperative in a written notice mailed to such person during the payment period described in section 1382(d)."

It is likely that many cooperatives, particularly those that pay patronage dividends relatively soon after year end, will not yet know the precise amount of their Section 199 deduction for a year when patronage dividends are paid. To determine the amount of the Section 199 deduction, a cooperative's tax return will need to be substantially complete. However, Section 6072(d) provides cooperatives with a due date (without extensions) for their tax returns that is eight and one-half months after year end.

Consequently, the effect of the provision as written is to require taxpayers to take the deduction at the time they receive their patronage payment (part of which is the "qualified payment"), even though they may be notified of the pass-through of the Section 199(a) deduction after they file their returns. This result would require taxpayers to file amended returns. A more efficient solution would be to allow taxpayers to take the deduction in the tax year in which they receive notice from the cooperative.

To illustrate our concern with the timing of the deduction, we offer the following example:

> Assume the facts are the same as the prior example except that the cooperative also engages in other nonmember/nonpatronage activities which result in net nonmember/nonpatronage income for the year of $500,000. At the time the cooperative pays its $1 million patronage dividend deduction (December 15, 2006), the cooperative has not yet completed its tax return and is uncertain as to the precise amount of its

> qualified production activities income and its Section 199(a) deduction. When the cooperative pays its patronage dividend, it passes through $25,000 of Section 199(a) deductions, determined based upon a conservative estimate. When the cooperative completes its 9/30/2006 tax return for filing in June 2007, the cooperative determines that it is entitled to a $30,000 Section 199 deduction for the year with respect to the business it conducts with its members. The cooperative sends notices to its members before June 15, 2007, notifying them that an additional $5,000 of Section 199(a) deductions passes through to them.

Must members amend their 2006 income tax returns if they want to claim the benefit of the additional Section 199(a) deductions passed through to them on June 15, 2007? That is what the statute seems to require. Given that many agricultural and horticultural cooperatives have thousands of members, that does not seem to us to be a practical result.

Clarify Deduction Applies to Goods Manufactured, Produced, Grown, or Extracted *within the United States*. Code Section 199(c)(4)(A)(i)(I) provides that income attributable to domestic production activities is income derived from "qualifying production property which was manufactured, produced, grown, or extracted by the taxpayer in whole or in significant part *within the United States* . . ." (emphasis added).

However, the language of Section 199(d)(3) leaves out these critical words in several places. The first is in the definition confirming that supply cooperatives can qualify as "specified agricultural and horticultural cooperatives." Section 199(d)(3)(F)(i) provides that it applies to cooperatives engaging "(i) in the manufacturing, production, growth, or extraction in whole or in significant part of any agricultural or horticultural products." In addition, Section 199(d)(3)(D) states that cooperatives "shall be treated as having manufactured, produced, grown, or extracted in whole or significant part any qualifying production property marketed by the organization which its patrons have so manufactured, produced, grown, or extracted."

We recommend that the phrase "within the United States" be added to Sections 199(d)(3)(D) and 199(d)(e)(F)(i).

Eliminate Ambiguity Regarding Supply Cooperatives. The statutory language as proposed in the Act (Code Section 199(d)(3)(F)(i)) provides that the pass-through provisions apply to Subchapter T cooperatives engaged "in the manufacturing, production, growth, or extraction in whole or significant part of any agricultural or horticultural product . . ."

This language is intended to include supply cooperatives, as was made clear in Footnote 33 of the Managers' Report to the AJCA (H.Rept. 108-755):

> "33. For this purpose, agricultural or horticultural products also include fertilizer, diesel fuel and other supplies used in agricultural or horticultural production that are manufactured, produced, grown, or extracted by the cooperative."

See also Notice 2005-14, 2005-7 I.R.B. 498 (February 14, 2005), Section 4.07 (last sentence), which repeats this language.

Clearly, Congress intended that supply cooperatives be eligible for the pass-through provision. We recommend that the statute be clarified as follows (clarifying language is underlined):

> "(F) SPECIFIED AGRICULTURAL OR HORTICULTURAL COOPERATIVE. – For purposes of this paragraph, the term 'specified agricultural or horticultural cooperative' means an organization to which part I of subchapter T applies which is engaged—
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> "(i) in the manufacturing, production, growth, or extraction in whole or significant part in the United States of any agricultural or horticultural products (including any supplies used in agricultural or horticultural production), or
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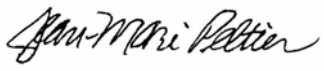
> "(ii) in the marketing of agricultural or horticultural products."

Clarify Treatment of Wage Limitation. The statute should clarify that the Section 199 deduction of a cooperative is subject to the W-2 wages limitation at the cooperative level only and that it is not subject to a second W-2 wages limitation at the patron level if it is passed through to the patron.

We recommend that the statute be clarified by adding the following sentence at the end of Section 199(d)(3)(A): "The limitation of Section 199(b) does not apply to the amount received from an organization to which part I of subchapter T applies."

We appreciate the opportunity to make comments with respect to the application of Section 199 to farmer cooperatives and their members. We would be happy to answer any questions you may have regarding our comments; please direct your questions to Marlis Carson, General Counsel, at 202-879-0825.

Yours very truly,



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