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Domestic Production Activity Deduction for Members of Cooperatives

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February 12, 2009
Updated May 24, 2013
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Overview

Farmers are receiving Form 1099-PATR as well as statements about the pass-through of the domestic production activities deduction[1] (DPAD) from their cooperatives. These forms and statements have generated a number of questions from farmers and their income tax preparers. While the rules are confusing, they can have a significant positive effect on the tax returns of members of cooperatives that elect to pass the DPAD through to their members.

Many questions have been raised, but one of the most common questions is how the increased amounts being reported in Box 3 of the Form 1099-PATR should be reported on a farmer's income tax return. To address that question and related issues, this article begins with a discussion of the DPAD as it applies to cooperatives and their members and then directly addresses the questions raised by the tax forms and statements being sent by cooperatives.

Statutory Background

I.R.C. § 199 allows taxpayers to claim a deduction on their income tax return based on their net income from most production activities in the United States. The domestic production activities deduction (DPAD) for tax years beginning in 2007, 2008 and 2009 is limited to the lesser of:

- 6% of the qualified production activities income (QPAI);
- 6% of the entity's taxable income without regard for I.R.C. § 199 (modified adjusted gross income for individual taxpayers); and
- 50% of Form W-2 wages paid during the year by the taxpayer that are allocable to domestic production gross receipts (DPGR)[2]

Note: Except for the oil and gas industry, the 6% rate increases to 9% for tax years beginning after 2009. (The deduction rate was 3% in 2005 and 2006.)

QPAI. QPAI equals domestic production gross receipts (DPGR) reduced by the sum of the following:

- Cost of goods sold (CGS) allocable to DPGR;
- Other deductions and expenses directly allocable to DPGR; and
- A share of other deductions and expenses that are not directly allocable to DPGR or another class of income

Observation: QPAI for many farmers is the sum of their net income reported on Schedule F (Form 1040), Profit or Loss from Farming, and net gain from sale of raised livestock reported on Form 4797, Sales of Business Property. However there are exceptions to this general rule.

DPGR. DPGR are receipts derived from the lease, rental, license, sale, exchange, or other disposition of qualifying production property that is manufactured, **produced, grown,** or extracted by the taxpayer in whole or in significant part within the United States.[3] Qualifying activities include cultivating soil, raising livestock, and fishing as well as storage, handling, and other processing (other than transportation activities) of agricultural products.[4]

Wages. For many farmers, the 50% of wages limitation is the major limiting factor on their DPAD. Many farmers have little or no paid labor. In addition, wages for which withholding is not required are excluded from "Form W-2 wages."[5] Thus, wages paid in commodities, wages paid for agricultural labor to a child of the proprietor that is under age 18 or to a child under age 18 who is the child of all the partners in a partnership, and compensation paid in the form of nontaxable fringe benefits are not included in "Form W-2 wages."

> **Note:** For tax years beginning after May 17, 2006, only the wages allocable to DPGR are qualified wages for the 50% of wages limitation.

The DPAD and Cooperatives

In general. The DPAD can be confusing for members of cooperatives. Unlike the treatment of owners of other pass-through entities such as partnerships and S corporations, the DPAD deduction for products sold by a cooperative is calculated at the entity level and the cooperative can elect to pass part or all of the DPAD through to its members based on their patronage.[6] Because the DPAD is calculated at the cooperative level and the deduction passes through to the members of the cooperative, the deduction on the member's tax return is *not* limited by the member's adjusted gross income or Form W-2 wages.

Cooperative's DPAD. A cooperative engaged in marketing agricultural and horticultural products is treated as having produced any products that are produced by its patrons and marketed by the cooperative.[7] In determining the pass-through DPAD, the cooperative's taxable income and QPAI are computed without taking into account any deductions for patronage dividends, per-unit retain allocations, and nonpatronage distributions under I.R.C. § 1382(b) and (c).[8]

> **Note:** The DPAD is a deduction only against patronage-sourced income. The DPAD cannot be computed by aggregating patronage and nonpatronage-sourced income.[9] Since cooperatives compute gross patronage-sourced income for DPAD purposes without deducting PURPIMS, patronage-sourced income is higher than it otherwise would be which gives cooperatives an advantage over corporations.

This rule led many cooperatives to take a closer look at how they characterize their payments to members for the members' commodities. That characterization depends on the member agreement with the cooperative. The IRS was asked to examine several agreements last year, and issued five private letter rulings on the matter in 2008.[10] In each of the rulings, IRS said that the payments a cooperative makes to its members for their commodities are advance per unit retains payments in money (PURPIM). Consequently, the cooperatives do not have to deduct those payments from their DPGR to compute their QPAI. The result is that a cooperative's ability to treat the payments for commodities as PURPIM significantly increases the cooperative's QPAI and potentially the DPAD the cooperative can elect to pass through to its members.

Example:

Ruraltown Farmer's Cooperative is a marketing cooperative that had $5,000,000 in gross receipts in 2008 from the sale of corn its members delivered to it, who are the farmers that produced the corn. Ruraltown paid $4,000,000 to its members at the time they delivered the corn and another $500,000 in patronage dividends after the close of the 2008 tax year. Ruraltown also had $500,000 of other expenses that includes $120,000 of wages.

Historically, Ruraltown treated the payments to its members at the time they delivered corn as payments for the purchase of the corn. However, after reviewing its membership agreement in light of the letter ruling issued by the IRS, Ruraltown concluded that those payments are advance PURPIM. Therefore, it did not deduct those payments from DPGR to compute its QPAI for 2008 and it included those payments in Box 3 of the 2008 Forms 1099-PATR it sent to its members.

Because Ruraltown marketed grain produced by its members, all of its receipts are DPGR. Consequently all of its expenses are allocable to DPGR and its QPAI is $4,500,000 ($5,000,000 - $500,000).

Note: If Ruraltown's payments to members at the time they delivered corn were purchases of the corn, the $4,000,000 cost of the corn would be an expense that is deducted from the cooperative's DPGR, which would reduce the cooperative's QPAI to $500,000 ($5,000,000 - $500,000 – $4,000,000).

Ruraltown's DPAD is $30,000, which is the least of:

1. 6% of its $4,500,000 QPAI, which is $270,000
2. 6% of its $500,000 taxable income, which is $30,000, or
3. 50% of its $120,000 wages, which is $60,000.

The DPAD of Cooperative Members

The member's deduction is the DPAD of the cooperative that is allocable to the following:

- Patronage dividends paid to the patron in money, a qualified notice of allocation, or other property (except a nonqualified written notice of allocation); and
- Per-unit retain allocations that are paid to the patron in qualified per-unit retain certificates

Note: A cooperative must designate the patron's portion of the income allocable to QPAI in a written notice mailed by the cooperative to the patron no later than the fifteenth day of the ninth month following the close of the tax year.[11]

Example:

Based on the example above, Joe Corngrower, a member of Ruraltown Farmer's Cooperative, marketed 50,000 bushels of corn through Ruraltown in 2008, which was 2% of all the grain Ruraltown marketed that year. Ruraltown elected to pass its entire $30,000 DPAD through to its members and allocated 2% ($600) of it to Joe. Joe reports that $600 DPAD on line 21 of his 2008 Form 8903, Domestic Production Activities Deduction. Joe can deduct that full $600 regardless of his adjusted gross income (AGI) or Form W-2 wages because a DPAD that is passed through from a cooperative is not subject to the 6% of AGI or 50% of wage limitations on the member's income tax return.

No double counting. The regulations specify that a qualified payment received by a patron of a cooperative is not taken into account by the patron for purposes of section 199."[12] Therefore, patronage dividends paid to the patron in money, a qualified notice of allocation, or other property (except a nonqualified written notice of allocation) or in per-unit retain allocations that are paid to the patron in qualified per-unit retain certificates are not included in a member's DPGR.

It is important to note that this rule excludes the listed items from the member's DPGR whether or not the cooperative elects to pass part or all of its DPAD through to its members. Therefore, the cooperative's election to pass through DPAD to its members has no effect on the members' DPGR.

Example:

Based on the previous examples, Joe Corngrower cannot include the payments he received from Ruraltown in his DPGR because Ruraltown has characterized those payments as PURPIM and patronage dividends. He cannot include those payments in his DPGR even if Ruraltown passed none of its DPAD through to its members.

Effect of 5% safe harbor. There is no guidance on the interaction of Treas. Reg. § 1.199-6(l) and the safe harbor under Treas. Reg. § 1.199-1(d)(3)(i) that allows a taxpayer to treat all receipts as DPGR if less than 5% of the taxpayer's total gross receipts are non-DPGR. That raises a question as to whether a patron who qualifies for the 5% safe harbor can include qualified payments from a cooperative in DPGR because all receipts are included (due to the safe harbor). An alternative possibility is that Treas. Reg. § 1.199-6(l) overrides the 5% safe harbor and excludes the qualified payments from the patron's DPGR.

In general, a more specific rule takes precedence over a more general rule if they are in conflict. Because Treas. Reg. § 1.199-6(l) is the more specific rule in this case it would seem to take precedence over the 5% safe harbor.

Cooperative's DPAD is not reduced. I.R.C. § 199(d)(3) and Treas. Reg. § 1.199-6 do not explicitly state the effect of a cooperative's election to pass its DPAD through to it patrons on the amount of the DPAD that the cooperative can claim. Neither the Code nor the Regulations require the cooperative to reduce its DPAD deduction. However, Example (2) of Treas. Reg. § 1.199-6(m) allows the cooperative, to deduct the full amount of the DPAD that it passed through to its patrons. In addition, IRS has ruled that a cooperative remains entitled to claim the entire section 199 deduction on its return (provided that it does not create or increase a patronage tax loss).[13]

I.R.C. § 199(d)(3)(B) and Treas. Reg. § 1.199-6(b) require the cooperative to reduce the deduction it would otherwise claim against its taxable income under I.R.C. § 1382(b) for per-unit retain allocations and patronage dividends by the amount of the DPAD that it elects to pass through to its patrons. The reduction of that deduction has the same effect on the cooperative's taxable income as reducing the cooperative's DPAD by the DPAD passed through to the cooperative.

Reporting on Farmers' Tax Returns

Based on the preceding analysis, many of the questions raised by the Forms 1009-PATR and DPAD statements that are presently being sent to farmers by cooperatives can be addressed.

Question 1: The original 2008 Form 1099-PATR my client received from her cooperative reported $10,000 in Box 3, which is the per unit retain that she received in January 2008 based on the grain she marketed through the cooperative in 2007. An amended 2008 Form 1099-PATR increases the amount reported in Box 3 by the $100,000 of grain that she delivered in 2008 and for which she was paid in 2008. If I report this entire amount on line 5b of Schedule F (Form 1040), the grain sales will be included in income twice. How should the amount in Box 3 be reported?

Answer 1: By reporting the $100,000 the member received for grain sales in Box 3 of Form 1099-PATR, the cooperative is stating that the payment for grain is a per unit retain paid in money (PURPIM). That determination is based on the membership agreement. Because of that determination, the $100,000 from the cooperative for the grain should not be reported as grain sales on line 4 of Schedule F (Form 1040). It should be included on both lines 5a and 5b of Schedule F (Form 1040).

> **Note:** Reporting the $100,000 for grain as part of the PURPIMs on line 5b

of Schedule F (Form 1040) is consistent with the Treas. Reg. § 1.199-6(l) statement that those payments are not included in the member's DPGR. Your client's 2008 DPGR does not include the $100,000 she received for the grain.

Question 2: This same client received a statement from her cooperative that says it has elected to pass through 60% of its DPAD to its members and my client's share of the pass-through is $3,600. The $3,600 is reported in Box 6 of her 2008 Form 1099-PATR. I understand that the $3,600 is reported on line 21 of my client's 2008 Form 8903, Domestic Production Activities Deduction. Because that amount is only 60% of the DPAD that the cooperative could have passed through to my client, can I include 40% of her $100,000 milk sales in her 2008 DPGR to calculate her DPAD?

Answer 2: No, because the cooperative has determined that its payments for members' grain are advance payments of PURPIMs, those payments are not included in the members' DPGR regardless of the cooperatives election to pass through some, all, or none of its DPAD.

Question 3: My client received a 2008 Form 1099-PATR with $270,000 in Box 3. That amount matches the $20,000 he received in PURPIMs in 2008 and his $250,000 of milk checks that he received in 2007. I reported that $250,000 as milk income on his 2007 income tax return. How should I report the $270,000 shown in Box 3 on his 2008 income tax return?

Answer 3: Some cooperatives calculated the 2008 DPAD that they passed through to a member based on the commodities the member delivered in 2007. They then reported the 2007 payments for commodities in Box 3 of the 2008 Form 1099-PATR so that it is consistent with the DPAD that is passed through in Box 6 of the 2008 Form 1099-PATR. With hindsight, they agree that the 2007 payments should have been reported in Box 3 of the 2007 Form 1099-PATR. However, they are not sending amended Forms 1099-PATR.

To work around this reporting problem, you should report the full $270,000 from Box 3 of Form 1099-PATR on line 5a of the 2008 Schedule F (Form 1040) but report only $20,000 on line 5b. Attach a statement to the return that says the $250,000 was reported as milk income on your client's 2007 income tax return.

If you included the $250,000 of milk income in your client's DPGR to calculate the client's 2007 DPAD, advise the client to amend the 2007 tax return to report a DPAD that is based on DPGR without the $250,000 of milk income. That is true whether or not the cooperative elected to pass its DPAD through to its members. The cooperative's determination that the 2007 payments for milk are advance payments of PURPIM excludes those payments from the members' DPGR without regard to the cooperative's DPAD pass-through election.

Question 4: My client is member of a cooperative that received one of the private letter rulings in 2008 that are mentioned above. The cooperative sent two statements to my client – both in August of 2008. One reported my client's 2007 DPAD, and the other reported his 2008 DPAD. The 2008 Form 1099-PATR shows the DPAD for both years in box 6 as a deduction for the 2008 calendar year. Can I take only the 2008 DPAD and file an amended return for 2007 using the 2007 DPAD allocation, or must I take the DPAD for both years in 2008?

Answer 4: The statements from the cooperative appear to be inconsistent with the Form 1099-PATR. You could request corrected Forms 1099-PATR for both 2007 and 2008. If the cooperative does not provide the corrected forms, you could report the DPAD shown in the statements on an amended 2007 return and an original 2008 return and attach a statement to each return explaining that the DPAD statements and Forms 1099-PATR did not match.

Question 5: Does the 2008 per unit retain allocation include the grain sold on a deferred payment contract that the cooperative member received in 2009?

Answer 5: No**.** If the cooperative has determined that payments to its members for grain are advance PURPIM, the deferred payments received in 2009 are PURPIM in 2009 and should be reported as per unit retain allocations on the 2009 Form 1099-PATR. If the cooperative has determined that payments to its members for grain are grain purchases, the deferred payments are not per unit retain allocations in either 2008 or 2009. They are grain sale revenue in 2009.

Question 6: My client sold approximately 50 percent of their grain to a local cooperative and received a 1099-PATR with amounts in Boxes 1, 3 and 6. If the client's qualifying gross receipts are reduced by the Box 3 amount, the client's remaining qualifying income is less than the taxpayer's farm expenses resulting in no QPAI and no deduction for the business production/farm activity that was not sold to the cooperative. Can the client allocate farm expenses in some reasonable manner to the cooperative income and non-cooperative income so that a DPAD is available on the amount of the production not sold to the cooperative?

Answer 6: Yes. Prop. Treas. Reg. §1.199-4(f) allows eligible taxpayers to allocate costs between DPGR and non-DPGR by using the ratio or DPGR to total gross receipts. Eligible taxpayers include farmers who are not required to use accrual accounting. Therefore, farmers who receive per-unit retains or patronage dividends from a cooperative for part of their commodities and sell part of their commodities through other markets can allocate their production costs between the commodities on a pro-rata basis.

Question 7: In January, a local cooperative issued a "revised patronage statement" reporting per unit retain allocations for 2008, and then issued the normal 2009 patronage dividend in the same format. How do I, as the tax practitioner, handle this?

Answer 7: Make sure that the deductions that have been withheld from the grain checks plus the net checks reported as grain sales match the amount on the 1099-PATR. This may cause some issues if the farmer is short of what should have been reported. The real question is whether the farmers need to worry about what has been reported on the patronage statement. IRS can match these amounts with what has been reported on Schedule F. The Farmers' Tax Guide (Pub. 225) clearly states that the stated dollar value of qualified written notices of allocation should be reported on lines 5a and 5b of Schedule F. So, it is important to include everything in Box 3 of the Form 1099-PATR on line 5a of Schedule and, in most cases, also on line 5b (the only amount excluded from line 5b is the non-qualified per-unit retains or an erroneous amount reported in Box 3).
To avoid over-reporting of income, practitioners should be careful to do any of the following that are appropriate to the facts:

- If the amount reported in Box 3 is incorrect, attach a statement to explain the error. For instance, if the cooperative has incorrectly reported payments for grain that were paid in 2008 (and reported by the member as grain income on the member's 2008 tax return) in Box 3 of the 2009 Form 1099-PATR, the member should report the full amount from Box 3 on line 5a and exclude the grain sales reported in 2008 from line 5b. A statement should be attached to the return explaining that the amount excluded was previously reported as grain sales in 2008.
- Payments reported in Box 3 of the 2009 Form 1099-PATR and received from the cooperative in 2009 should be reported on lines 5a and 5b of Schedule F and not on line 4 of Schedule F.
- If expenses were deducted from checks the cooperative paid to the member, but the amount reported in Box 3 is not reduced by the withheld expenses, report the amount in Box 3 on lines 5a and 5b and deduct expenses in Part II of Schedule F.

Question 8: I am confused about the amounts reported in Box 3 of the 1099-PATR. Some practitioners are combining the amounts in Box 3 and Box 1 and putting the combined amount on line 5a of Schedule F, but only the Box 1 amount on line 5b of Schedule F. The difference between Box 3 on the 1099-PATR and what the farmer reports as revenue are settlement charges which have never been reported. How should this be handled?

Answer 8: It is not correct to report payments for grain that the cooperative treats as per-unit retains and reports in Box 3 of Form 1099-PATR as grain sales that are reported on line 4 of Schedule F. As mentioned above, IRS will look for the Box 3 amount on lines 5a and 5b of Schedule F. There is a substantive difference between receiving a per unit retain for grain (reported in Box 3 of Form 1099-PATR and on lines 5a and 5b of Schedule F) and selling the grain to the cooperative (reported on line 4 of Schedule F). The amount reported in Box 3 is not included in the farmer's DPGR regardless of the cooperative's election to pass its DPAD through to its members. Thus, in most cases, the full amount in Box 3 should be included on line 5b. As mentioned above, the only reason for not including an amount from Box 3 on line 5b is that the per-unit retain is non-qualified and, thus, not deductible by the cooperative. In that case, it is not taxable to the member and the member has no basis in that equity in the cooperative.

Settlement charges should be reported as an expense on Schedule F and not be excluded from line 5b. This will work to the taxpayer's advantage because it increases gross receipts from farming without increasing net farm income.

Question 9: My client received a K-1 from an ethanol plant. Most of the K-1s had losses with no resulting DPAD. But, the cost of goods sold, deductions and losses were carried forward to 2009 pursuant to Treas. Reg. §1.199-9. How do I handle this?

Answer 9: Deductions that are disallowed by the at-risk rules (I.R.C. §465), the passive loss rules (I.R.C. §469) or the partnership basis rules (I.R.C. §704(d)) are not taken into account in computing the partner's DPAD for the year the expenses are incurred. Instead, they are taken into account in the tax year they are allowed as a deduction. Take a look at Treas. Reg. §1.199-5(a)(2).

Question 10: My client had $500,000 in grain sales and $400,000 in Schedule F expenses, including $30,000 of wages. $150,000 of the grain sales were reported by the cooperative as per-unit retains. The remaining sales were to non-cooperatives such as ethanol plants. The cooperative did not pass-out any DPAD on the 1099-PATR. If it weren't for the grain sales to the cooperative, the farmer's DPAD would have been $6,000 ($500,000-$400,000 = $100,000 x .06 = $6,000). If sales are reduced by the per-unit retains, the farmer's DPAD would be $0 ($500,000-$150,000 = $350,000 and $350,000 - $400,000 = $-50,000). If DPGR doesn't include the per-unit retains, can expenses be reduced by the cost of producing them? Very few farmers are able to generate an accurate cost of goods sold figure. So, can expenses be allocated? For example can I compute it as follows: [($350,000/$500,000) x $400,000 = $280,000] or is the farmer stuck with reducing DPGR without a corresponding reduction in expenses?

Answer 10: The costs can be allocated pro-rata between DPGR from non-cooperative sales and the per-unit retains. So, the $280,000 of the expenses can be allocated to the per-unit retains leaving only $120,000 to subtract from the $150,000 DPGR for a $30,000 QPAI and an $1,800 DPAD (subject to the AGI and wage limits). As for costs of goods sold, the Code and Regulations do not require a taxpayer to come up with the cost of goods sold if their method of accounting does not otherwise require that number. Thus, for most farmers, they do not need a cost of goods sold and can allocate their Schedule F expenses pro-rata.

Question 11: With respect to the 1099-PATR, should I add Box 1 plus Box 3 and include that on lines 5a and 5b of Schedule F? If so, should I subtract all the Box 3 amounts from line 4 of the Schedule F?

Answer 11: Yes. Report all of Box 1 and Box 3 from the 1099-PATR on line 5a of Schedule F an exclude only non-qualified patronage dividends and per-unit retains from line 5b. Payments for commodities that are reported in

Box 3 of Form 1099-PATR should not be reported on line 4 of Schedule F.

Summary

By itself, the DPAD is complicated and confusing. But, the tax rules for a cooperative's DPAD are even more complicated and they are different from the rules that apply to other entities. In addition, the differences among cooperatives add to the confusion. Some of the more confusing issues are:

1. Payments from cooperatives for members' commodities have traditionally been reported by the cooperative and the members as a sale of the commodity to the cooperative. The DPAD rules have caused cooperatives to look more closely at that characterization because of the tax benefits of treating those payments as per unit retains paid in money (PURPIM). Many cooperatives have concluded those payments are PURPIM and therefore do not have to be subtracted from the cooperative's DPGR to compute their QPAI. Another consequence of that characterization is that the members cannot include the payments they receive from the cooperative in their DPGR when they compute their own DPAD.

2. The cooperative chooses how much, if any, of its DPAD that it passes through to it members. The cooperative's choice has no effect on its members DPGR because members cannot include PURPIM or patronage dividends in their DPGR regardless of the cooperatives choice of how much DPAD is passed through to members.

3. Some cooperatives have calculated their 2009 DPAD based on commodities delivered to them in 2008 while others have computed their 2009 DPAD based on commodities delivered to them in 2009. The year on which the DPAD is based affects the members of the cooperative because, in most cases, that is the first year the cooperative has treated all of its payments to its members as PURPIM or patronage dividends and therefore is the first year the members must exclude all payments from the cooperative from their DPGR.

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[1] I.R.C. §199

[2] I.R.C. §199 (b)(2)(A); Treas. Reg. §1.199-2

[3] I.R.C. §199 (c)(4).

[4] Treas. Reg. § 1.199-3(e)(1).

[5] See Rev. Proc. 2006-22, 2006-22 I.R.B. 1033.

[6] I.R.C. §199(d)(3).

[7] I.R.C. §199(d)(3)(D); Treas. Reg. §1.199-6(d). Any farmers' cooperative exempt from tax under I.R.C. § 521 qualifies if it is engaged in the MPGE of any agricultural or horticultural product or in the marketing of any agricultural or horticultural product. I.R.C. §199(d)(3)(F). Taxable corporations operating on the cooperative basis are also eligible for DPAD on its patronage-sourced income.

[8] I.R.C. §199(d)(3)(C); Treas. Reg. §1.199-6(c). See also Priv. Ltr. Rul. 201250009 (Sept. 11, 2012)(cooperative's DPAD to be computed without regard to any deduction for taxpayer's grain payments to member and participating patrons).

[9] F.S.A. 20131802F (Feb. 27, 2013).

[10] Priv. Ltr. Rul. 200838011 (Sept. 19, 2008); Priv. Ltr. Rul. 200843015 (Oct. 24, 2008); Priv. Ltr. Rul. 200843016 (Oct. 24, 2008); Priv. Ltr. Rul. 200843023 (Oct. 24, 2008); Priv. Ltr. Rul. 200852022 (Dec. 26, 2008).

[11] I.R.C. §199(d)(3)(A)(ii).

[12] Treas. Reg. §1.199-6(l).

[13] Priv. Ltr. Rul. 200838011 (Sept. 19, 2008).