Office of Chief Counsel
Internal Revenue Service
Memorandum

Number: **200729035**
Release Date: 7/20/2007

CC:CORP:B04
POSTS-153917-06

Third Party Communication: None
Date of Communication: Not Applicable

UILC: 1381.02-00, 1502.13-00

date: April 11, 2007

to:

(Large & Mid-Size Business)

from: Marie C. Milnes-Vasquez
Senior Technician Reviewer, Branch 4
(Corporate)

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subject: Controlled Cooperative Issues

<u>LEGEND</u>

Taxpayer =

Sub1 =

Company =

Procurement Division =

National Cooperative =

Regional Cooperative A =

Promoter =

Products	=
<u>a</u>	=
<u>b</u>	=
<u>c</u>	=
<u>d</u>	=
<u>e</u>	=
<u>f</u>	=
<u>g</u>	=
<u>h</u>	=
<u>i</u>	=
<u>j</u>	=
<u>k</u>	=
<u>l</u>	=
<u>m</u>	=
<u>n</u>	=
<u>o</u>	=
<u>p</u>	=
Year 1	=
Year 2	=
Year 3	=
Year 4	=
Year 5	=

Year 6	=
Year 7	=
Year 8	=
Year 9	=
Year 10	=
Year 11	=
Month 1	=
Month 2	=
Month 3	=
Month 4	=
Month 5	=
Date 1	=
Date 2	=
Date 3	=
Date 4	=
Date 5	=
Date 6	=
Date 7	=
Date 8	=
Date 9	=
Date 10	=
Date 12	=

Date 13 =

FACTS

I. In General

Taxpayer (Parent) is the common parent of an affiliated group of corporations that files a consolidated Federal income tax return. The primary business of the group is to market and distribute Products to domestic and foreign markets. Parent conducts its U.S. operations through approximately k domestic operating companies (Domestic OpCos) and n foreign operating companies (Foreign OpCos) (together the "Operating Companies"). The Parent consolidated group purchases items for distribution from thousands of suppliers.

The Parent consolidated group is under audit for taxable years ended Date 1 and Date 2. National Cooperative is under audit for taxable years ended Date 3 and Date 4. National Cooperative is a third-tier unconsolidated subsidiary of Parent, which was organized to qualify as a cooperative entity to which the rules of sections 1381 through 1388 (Subchapter T) of the Internal Revenue Code (Code) are applicable.

II. Former Structure - the Procurement Division

Prior to Year 1, the Operating Companies individually negotiated purchase prices with suppliers. The Domestic OpCos also purchased certain items at prices that were negotiated by Parent for use on a national level. In Year 1, Sub1, a domestic subsidiary of Parent, began to negotiate purchase contracts for use by the Domestic OpCos on a national basis. In Year 2, Sub1 reorganized as a cooperative under Subchapter T and was renamed Company. The Domestic OpCos were members of the Company cooperative. In Year 3, Company merged into, and became the procurement division of Parent. In Year 4, Parent's procurement division was renamed Procurement Division.

Parent's Procurement Division negotiated two types of contracts: (i) contracts negotiated under a Corporate Billed program; and (ii) contracts negotiated under a Supplier Billed program. Under the Corporate Billed program, the Operating Companies placed orders with suppliers at rates negotiated by the Procurement Division. The suppliers billed Parent at the vendor list price, and Parent billed the Operating Companies at the vendor list price. The suppliers separately paid to Parent any rebates, promotional funds, or other negotiated discounts (Earned Income). Parent, in turn, paid such amounts to the Operating Companies. These discounts represented a substantial element of the profit margins of the Operating Companies.

Under the Supplier Billed program, the Operating Companies ordered from the suppliers at the prices negotiated by the Procurement Division but paid the suppliers the vendor list price. The supplier separately paid any Earned Income (including the negotiated discount) to Parent, who then conveyed such payments to the OpCos. For contracts negotiated by the Procurement Division, the only significant difference between the Corporate Billed program and the Supplier Billed program was whether the OpCos directly paid the supplier or whether the Parent acted as intermediary for the billing and payment.

In addition to Parent's negotiations through the Procurement Division, the Operating Companies individually negotiated discount prices with suppliers. The suppliers billed the Operating Companies at the vendor list price and the Operating Companies paid the suppliers the vendor list price. The supplier thereafter separately paid any Earned Income to the Operating Companies.

III. The Tax Shelter Promoter

In Year 5, a tax shelter promoter (Promoter) approached Parent with a tax strategy entitled "Operations Consolidation Strategy 'OpCo'." The Promoter made two presentations to Parent in Year 5. These presentations provided that the OpCo strategy could generate benefits to the Taxpayer in excess of $ a in the first year and an excess of $ b over five years. Although the presentation never expressly identifies these savings as tax savings, the presentation does not refer to efficiency or other business-related savings. Rather the only savings discussed are state tax savings (comprising a single page of the presentation) and federal tax savings (the subject of the majority of the presentation).

To achieve these savings, the Promoter advised the use of a particular cooperative structure. In both presentations, the Promoter advised the following:

- Identify services to be performed by cooperative
- Identify a non-consolidatable entity that will have a membership interest:
  - Generally, should have 1 non-consolidatable member for every 3 consolidatable members
- Cooperative will not meet the 80% voting requirement for consolidated group purposes
- Cooperative can adopt a tax year-end different from its members
- Develop valuation model for arm's length pricing
- Structure can result in "permanent" tax deferral

The Promoter further advised that:

Maximum tax deferral results from Op-Co Strategy when:

- Coop is excluded from consolidated group filing;

- Coop elects a tax year-end 4 months after year end of its members[;]
- Patronage dividends are paid within 8 ½ months after coop's tax year-end; and
- Patrons record income when patronage dividends are received.

On Date 5, Parent hired the Promoter at a fixed fee of $ c. The Promoter was to provide "tax consulting services . . . relative to the design and implementation of the Op-Co Strategy."

IV. Taxpayer's Correspondence

In a Date 6 memo titled "Co-op tax project," Parent's controller advised its chief financial officer as follows:

> As you and I have previously discussed, the success of the co-op as a tax strategy depends on the implementation of forward warehouses as a business model. . . . I am once again concerned that we have not developed our business plan to a level that would insure that we could defend the formation of regional co-ops against challenge by the I.R.S. The opinion letter from [the Promoter] contains a statement that says the first forward warehouse will be opened by [Date 7] with additional openings every six months until completion in [Date 8]. To my knowledge there is no CIP [construction in progress] for this project, no project director, and no plan document that lays out how and when these facilities are to be opened. Additionally, I am not sure that we have committed any significant resources to this project or even estimated the potential ROI [return on investment].
>
> In summary, I think this situation still requires additional discussion among senior management. I think it is important that we have a plan document and an appropriate project before we invest more professional fees in the tax strategy. . . .

Similarly, an internal finance and administration memorandum entitled "CO-OP TAX PROJECT" and dated Date 9 provided:

> The co-op tax project has significant positive cash flow benefits but also has significant cost penalties if the business does not support the tax strategy. . . .
>
> For a major component of this strategy, the flow and ownership of the product does not physically change from what is being done today, only the structure through which the transactions flow, changes. However, part of the strategy does have to do with the regional redistribution warehouses and logistics.

> I am very reluctant to move forward with this strategy without the business sponsorship and more importantly a specific plan for the development and implementation of the regional warehousing concept which has that business commitment.

In the course of the audit, the Taxpayer further reiterated in writing that, by spring of Year 6, the Taxpayer's senior management was concerned that Taxpayer had no business plan adequate to support implementation of the cooperative strategy. As such, in Month 1 of Year 6, Taxpayer directed the Promoter to suspend "its provision of tax consulting services relating to cooperative distribution until a committed business plan for implementation of the regional redistribution was completed."

In Month 2 of Year 6, Taxpayer hired a consultant to perform a feasibility study. In Month 3 of Year 7, Taxpayer directed the Promoter "to resume providing tax consulting services relating to the cooperative structure including regional redistribution."

In a Date 10 document entitled "Proposal for Refinement of the [Parent Procurement] Services Function in Cooperation with [Promoter]", Taxpayer's Board of Directors set forth the projected economic benefit from the proposed structure. The Board provided:

> Assuming a conservative estimated annual [patronage] dividend of $ [d], there could be a tax deferral of $ [e] ([f] percent of $ [g] for [h] months) resulting in an imputed interest savings of $ [i] (using a [j] percent interest rate). There is a continuing deferral as long as the benefits of a cooperative structure exist.

On Date 10, Taxpayer's Board of Directors approved the formation of the tax strategy and resolved that it would restructure Taxpayer's Procurement Division to operate as a cooperative under Subchapter T of the Code.

V. Formation of the Regional and National Cooperatives

The implementation of the Co-op tax strategy required several steps. In Month 4 of Year 7, Parent formed o second-tier domestic subsidiaries ("Regional Cooperatives"), each of which was organized to qualify as a cooperative entity to which Subchapter T would be applicable. Parent capitalized the Regional Cooperatives by transferring to them, in a purported § 351 transfer, assets of Parent's Procurement Division, including the supply contracts plus cash, in exchange for a membership interest. Each of the k Domestic OpCos became a member in one of the Regional Cooperatives by making a nominal capital contribution. Each of the Regional Cooperatives was included in the Taxpayer's consolidated group, as it was wholly-owned by members of that group. The Taxpayer has stated that the Regional Cooperatives were established to provide procurement, distribution and logistical services to the Domestic OpCos.

Membership in Regional Cooperatives was mandatory and non-transferable. The organizational documents did not restrict membership to Taxpayer's affiliated group; however, companies unrelated to the Taxpayer were not solicited for membership. Parent did not establish any foreign cooperatives.

Also in Month 4 of Year 7, the National Cooperative was formed, with the Regional Cooperatives transferring their assets to the National Cooperative in exchange for ownership interests. The employees that had formerly worked in Parent's Procurement Division were lent to the National Cooperative but continued in their former duties from the same workstations. In Month 2 of Year 7, the National Cooperative assumed the functions of Parent's Procurement Division, namely negotiating contracts for Parent's subsidiaries.

Each of the o Regional Cooperatives and the n Foreign OpCos holds a membership interest in the National Cooperative. Each membership interest in the National Cooperative entitles its holder to one vote. The Parent did not include the National Cooperative in Parent's consolidated tax return for the years under audit. Parent maintains that the ownership by the Foreign OpCos of membership interests in the National Cooperative results in the National Cooperative's failure to meet the 80% voting requirement under §1504(a)(2) for inclusion in Parent's consolidated return.[1] Although the Foreign OpCos held n of the p membership interests in the National Cooperative, the National Cooperative transacted l percent and m percent of its total business during its Year 8 and Year 9 years, respectively, with or on behalf of the Domestic OpCos.

After the National Cooperative began operations, the Operating Companies continued to place orders directly with suppliers at rates established by the National Cooperative. Under the Cooperative Billed Program, the National Cooperative placed orders with suppliers on behalf of the Operating Companies. The National Cooperative paid the discounted price to the supplier, but the Operating Companies paid the National Cooperative the full vendor list price. The value of the negotiated discount remained with the National Cooperative and constituted a part of the Earned Income which was eventually distributed to the Operating Companies (through the Regional Cooperatives) as a patronage dividend.

Under the Supplier Billed Program, the Operating Companies directly placed orders with the supplier and paid the full vendor list price. The supplier separately paid any Earned Income, including rebates, promotional funds or other negotiated discounts to the National Cooperative. The value of the negotiated discount again constituted a

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[1] Under section 1381, the patrons or members of a cooperative must control it under the principles of "democratic control." Because each of the p member patrons of the National Cooperative has one vote, Parent maintains that the status of the n Foreign Companies as nonmembers of the Parent group prevents the group from meeting the 80% voting power requirement of section 1504(a)(2).

part of the Earned Income which was eventually distributed to the Operating Companies (through the Regional Cooperatives) as a patronage dividend.

Parent facilitated the payment of patronage dividends by the National Cooperative by wiring funds from Parent's bank account into the National Cooperative's bank account. On the same day, the National Cooperative wired funds into the accounts of the Regional Cooperatives and the Foreign OpCos, and Parent swept these funds back into the Parent's account. Later, when the Regional Cooperatives needed to make patronage dividends to the Domestic OpCos, Parent wired funds into the Regional Cooperatives' accounts. On the same day, the Regional Cooperatives wired funds into the accounts of the Domestic OpCos, and Parent swept these funds back into the Parent's account.

VI. The Purported Business Purpose

Taxpayer maintains that its business purpose for undertaking the cooperative structuring was to increase incentives for operating companies to purchase centrally, to centralize accounts payable transactions, to protect Parent from regulatory enforcement actions, and to promote state tax savings. In addition, Parent maintains that the Regional Cooperatives were necessary to promote cost savings in warehousing and in transporting inventory.[2] However, for the periods under audit, the Regional Cooperatives did not operate any redistribution centers. Taxpayer's Year 9 tax return shows no activity in the Regional Cooperatives except sales and an equal amount of cost of goods sold. On Parent's Year 10 tax return, there was minor activity in Regional Cooperative A but the remaining Regional Cooperatives had only sales, cost of goods sold, interest income, and a patronage dividend deduction. To date, only Regional Cooperative A operates a redistribution center.[3] This facility became operational in Year 11.

VII. Putative Tax Effects of the Cooperative Tax Project

Taxpayer structured its tax shelter based on the model sold to it by the Promoter. First, the Regional Cooperatives members of Parent's consolidated group were incorporated with a tax year ending on or about Date 12. To create the maximum tax deferral promised under the Promoter's product, the National Cooperative was

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[2] In addition to the organizational restructuring, Parent's supply chain initiative was to include the implementation of a new sophisticated supply ordering and tracking software program. Form 8886, Reportable Transaction Disclosure Statement, attached to the National Cooperative's tax returns indicates that a fee was paid to the software company with regard to the "supply chain reorganization" transaction. Parent's Year 11 Annual Report touts the many efficiencies and costs savings generated by these software-ordering programs.

[3] For the tax years under audit there were no operational regional distribution facilities within the Regional Cooperatives. Taxpayer maintains that construction of a second facility has begun and that it has contracted to purchase land for a third facility.

incorporated as a non-consolidated member of the Parent consolidated group with a tax year ending four months after that of the Regional Cooperatives. As such, the National Cooperative's tax year ended on or about Date 13. As explained in the Promoter presentation, this staggering of taxable years between the National Cooperative and the consolidated group was intended to result in deferral of tax on an amount of income equal to the patronage dividend for up to 20 months.

Central to this tax deferral strategy is section 1382(d), which allows a cooperative to take a current "patronage dividend deduction" for the full amount of "patronage net earnings" distributed from the beginning of its taxable year through 8 ½ months after the close of its tax year. [4] This deduction offsets the National Cooperative's income related to transactions with the Domestic OpCos. However, under section 1385, the patrons report the distributed patronage net earnings (patronage dividends) in the year of receipt.

The first tax year for the national cooperative ended in Month 2 of Year 8. The National Cooperative distributed patronage net earnings related to its Year 8 taxable year to its members in Month 4 Year 9, 8 ½ months following the close of the National Cooperative's tax year. This distribution occurred shortly after the beginning of the patrons' taxable year ending Month 5 Year 10. Therefore, the Taxpayer argues that the cooperative tax strategy successfully achieves deferral of 20 months, from the end of the National Cooperative's taxable year to the end of the Taxpayer group's taxable year.[5]

LAW AND ANALYSIS

LAW

Section 1382(b) provides that a cooperative may deduct from gross income for any taxable year the patronage dividends that it pays during the "payment period" for such year. The "payment period" for any taxable year is the period beginning with the first day of such taxable year and ending with the 15th day of the ninth month following the close of such year. Sec. 1382(d). A "patronage dividend" is defined as an amount paid to a patron by a cooperative (1) on the basis of quantity or value of business done with or for such patron; (2) under an obligation to pay such amount, which existed before the cooperative 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. Sec. 1388(a).

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4 For the purposes of this Advice, it is assumed that the national cooperative is a corporation operating on a cooperative basis under section 1381.

5 The Taxpayer has not claimed additional deferral on account patronage dividends paid by the Regional Cooperatives to the Domestic OpCos.

Section 1385(a) provides that patrons must include in gross income patronage dividends from a cooperative. These amounts are includible in gross income in the tax year in which they are received even though the cooperative organization was allowed a deduction for such amounts in its preceding taxable year. § 1.1385-1(a).

Under section 1381(a)(2), the rules of subchapter T (including the rules relating to deduction and inclusion of patronage dividends, discussed above) apply to "any corporation operating on a cooperative basis," with exceptions that are inapplicable here. A corporation must meet certain requirements to be treated as operating on a cooperative basis. These include: (1) subordination of capital; (2) democratic control by the members; and (3) operation at cost, and the vesting in and allocation among the members of all fruits and increases arising from their cooperative endeavor. Puget Sound Plywood, Inc. v. Commissioner, 44 T.C. 305 (1965); Rev. Rul. 93-21, 1993-1 C.B. 188.

Further, the IRS has analyzed certain additional factors in determining whether a taxpayer qualified as a cooperative. Under this analysis: (i) the cooperative must be engaged in some joint effort actively with, for, or on behalf of its members; (ii) there must be a minimum number of patrons; and (iii) upon liquidation, current and former members must participate on a proportionate basis in any distribution of the cooperative's assets.

In addition to other requirements not relevant hereto, section 1504(a)(2) requires that, for a subsidiary to be included in a consolidated group, stock possessing 80-percent of the total voting power of the stock of that subsidiary must be held by other members of the consolidated group.

Section 1.1502-13 provides rules for taking into account items of income, gain, deduction, and loss of consolidated group members from intercompany transactions (intercompany transaction regulations). The purpose of the intercompany transaction regulations is to provide rules to clearly reflect the taxable income (and tax liability) of the group as a whole by preventing intercompany transactions from creating, accelerating, avoiding, or deferring consolidated taxable income (or consolidated tax liability). §1.1502-13(a)(1).

The timing rules contained in the intercompany transaction regulations are a method of accounting for intercompany transactions, to be applied by each member in addition to the member’s other methods of accounting. To the extent that the timing rules of §1.1502-13 are inconsistent with a member’s otherwise applicable methods of accounting, the timing rules of §1.1502-13 control. S’s or B’s application of the timing rules of §1.1502-13 to an intercompany transaction clearly reflects income only if the effect of that transaction as a whole (including, for example, related costs and expenses) on consolidated taxable income is clearly reflected. §1.1502-13(a)(3).

The regulations define “intercompany transaction” broadly, as any transaction between corporations that are members of the same consolidated group immediately after the transaction. The regulations further define “S” as the member transferring property or providing services, and “B” as the member receiving the property or services. §1.1502-13(b)(1).

S’s income, gain, deduction, and loss from an intercompany transaction are its intercompany items. An item is an intercompany item whether it is directly or indirectly from an intercompany transaction. §1.1502-13(b)(2)(i). S’s intercompany items include amounts from an intercompany transaction that are not yet taken into account under its separate entity method of accounting. §1.1502-13(b)(2)(iii).

B’s income, gain, deduction, and loss from an intercompany transaction, or from property acquired in an intercompany transaction, are its corresponding items. An item is a corresponding item whether it is directly or indirectly from an intercompany transaction (or from property acquired in an intercompany transaction). §1.1502-13(b)(3)(i). The recomputed corresponding item is the corresponding item that B would take into account if S and B were divisions of a single corporation and the intercompany transaction were between those divisions. §1.1502-13(b)(4).

The attributes of an intercompany item or corresponding item are all of the item’s characteristics, <u>except amount, location, and timing</u>, necessary to determine the item’s effect on taxable income (and tax liability). The regulations provide the following examples of “attributes”: character, source, treatment as excluded from gross income or as a noncapital, nondeductible amount, and treatment as built-in gain or loss under section 382(h) or 384. §1.1502-13(b)(6).

One of the principal rules within the intercompany transaction regulations that implements single entity treatment is the matching rule of §1.1502-13(c). Under the matching rule, S and B are generally treated as divisions of a single corporation for purposes of taking into account their items from intercompany transactions. §1.1502-13(a)(6). The matching rule provides a timing rule, which directs when B and S must take into account their items from an intercompany transaction. Under this timing rule, B takes its corresponding item into account under its own, separate entity accounting method. §1.1502-13(c)(2)(i). S takes its intercompany item into account to reflect the difference for the year between B’s corresponding item taken into account and the recomputed corresponding item (the item that B would have taken into account if S and B were divisions of a single corporation). §1.1502-13(c)(2)(ii).

The matching rule also provides guidance regarding the manner in which the single entity structure of the intercompany transaction rules affects the attributes of intercompany and corresponding items. This rule provides that the separate entity attributes of S’s intercompany items and B’s corresponding items are redetermined to the extent necessary to produce the same effect on consolidated taxable income (and consolidated tax liability) as if S and B were divisions of a single corporation, and the intercompany transaction were a transaction between divisions. Thus, the activities of both S and B might affect the attributes of both intercompany items and corresponding items. §1.1502-13(c)(1)(i).

Section 1.1502-13(h)(1) provides an anti-avoidance rule, which states:

> If a transaction is engaged in or structured with a principal purpose to avoid the purposes of this section (including, for example, by avoiding treatment as an intercompany transaction), adjustments must be made to carry out the purposes of this section.

ANALYSIS

I. Cooperative Rules in General

In general, as outlined above, to the extent that a cooperative operates in the prescribed manner and distributes its income to its patrons in compliance with the requirements of subchapter T, the cooperative may avoid any federal income tax on otherwise taxable income. Under section 1382(b), the cooperative may claim a deduction from its income in any taxable year for qualifying patronage dividends paid up to 8 ½ months following the close of that taxable year. The patronage distributions are included in the taxable income of the patrons in the year of receipt. Therefore, under such circumstances, the Code effectively grants a one-year deferral on the taxation of the income earned by the cooperative and distributed as patronage dividends.

II. Cooperatives and Patrons within a Consolidated Group

The outcome described above is clearly applicable to a cooperative and its patrons, where the entities are not members of the same consolidated group. However, if the cooperative (S) and the patron (B) were members of the same consolidated group, the timing rules of the intercompany transaction regulations would apply to ensure single entity treatment of the combined cooperative and patron. Under such circumstances, the payment of patronage dividends would qualify as intercompany transactions under the broad definition of that term. See §1.1502-13(b)(1)(i). Application of the matching rule of the intercompany transaction regulations would ensure that the intercompany item of S (the deduction of the cooperative) would be taken into account in the same taxable year as the corresponding item of B (the inclusion of taxable income by the patron) which was generated by the same intercompany transaction. Cf. §1.1502-13(c)(7)(ii), Ex. 8 (offsetting items due to intercompany payment of rent to be taken into account in a single taxable year).

The timing rule provided within the matching rule of §1.1502-13(c) directs when a consolidated group must take into account B's corresponding items and S's intercompany items from an intercompany transaction. Under this timing rule, B (the patron) takes its corresponding items into account under its accounting method. §1.1502-13(c)(2)(i). Therefore, the application of the rules of subchapter T to the receipt by the patrons of the patronage dividends would be unchanged, and the patrons would include such amounts in income in the year of receipt. Under the timing rule, S (the cooperative) would take its intercompany item into account to reflect the difference for the year between B's corresponding item taken into account and the recomputed corresponding item (the item that B would have taken into account if S and B were divisions of a single corporation). §1.1502-13(c)(2)(ii).

If the cooperative and patron had actually been divisions of a single corporation, a transfer of funds from one division (cooperative) to a second division (patron) would have resulted in no net income or deduction to the corporation. Therefore, application of the matching rule should result in the cooperative's taking into account its deduction in the same year in which the patron includes the patronage dividend in income. The inclusion of the two, completely offsetting items in a single taxable year would result in the same net outcome to the group that would have resulted if S and B were divisions of a single corporation (no net income or deduction).

Application of this timing rule would result in the cooperative taking into account its patronage deduction (its intercompany item) one year later than generally required outside of consolidation, under section 1382(b). Thus, a group that includes a cooperative and its patrons would not be able to take advantage of the deferral provided under the rules of subchapter T, and would obtain a different outcome than is otherwise provided under the Code and regulations. However, this result is explicitly contemplated by the regulations. See, e.g., §1.1502-13(c)(7)(ii), Ex. 5(e) (otherwise available installment reporting denied under single-entity principles); see also §1.1502-13(a)(3) (to the extent the timing rules of §1.1502-13 are inconsistent with a member's otherwise applicable methods of accounting, the timing rules of §1.1502-13 control).

Further, this outcome comports with the purpose of the intercompany transaction rules, which is to provide rules to clearly reflect the taxable income and liability of the group as a whole, by preventing intercompany transactions from creating, accelerating, avoiding or deferring consolidated taxable income or liability. To the extent that the cooperative and its patron group as a whole were able to take advantage of the rules of subchapter T to gain deferral of tax on an amount equal to the patronage dividend, the group would be able to use an intercompany transaction (payment of the patronage dividend) to defer consolidated taxable income. The group (through the patrons) paid market price for goods received from the third-party supplier, and the supplier returned to the group (in particular, the cooperative) a portion of that price. Therefore, economically, the group as a whole has not borne an expense equal to the full market price. Yet, because of the status of the cooperative and the fact that, within 8 ½ months following the end of the taxable year, the cooperative will transmit the amount of the payment from the supplier back to the patron, application of the rules of subchapter T would allow for deferral by the group of tax on an amount equal to the patronage dividend through the use of an intercompany transaction.[6]

III. Application of the Anti-avoidance Rule to the Taxpayer's Structuring

As discussed above, the Taxpayer organized the National Cooperative to have p members, all with equal voting rights. o of those members were also members of the Taxpayer's consolidated group, whereas the remaining n were wholly-owned foreign subsidiaries. Thus, the Taxpayer argues that the National Cooperative does not meet the 80-percent voting power requirement of section 1504(a)(2), that it may not be included in the Taxpayer's consolidated group, and that the intercompany transaction regulations do not apply to transactions between the National Cooperative and members of the group. However, the anti-avoidance rule of §1.1502-13(h)(1) provides that:

> If a transaction is engaged in or structured with a principal purpose to avoid the purposes of this section (including, for example, by avoiding treatment as an intercompany transaction), adjustments must be made to carry out the purposes of this section.

Under the facts presented, the anti-avoidance rule should apply. The Promoter presentations and the Taxpayer's internal memoranda clearly demonstrate that the cooperative structuring was pursued with a purpose of achieving deferral of taxation on the amount of the negotiated discounts. Such deferral would enable the group to claim a cost of goods in excess of the actual, negotiated price, and thus to shelter other income. The documentation also shows that avoidance of the application of the intercompany transaction rules (and thus the single-entity principles underlying them) to the patronage distributions from the National Cooperative to members of the consolidated group was a principal tactic underlying the cooperative tax strategy. Further, the Regional Cooperative structuring through which the Taxpayer attempted to prevent consolidation of the National Cooperative relied on intercompany transactions between the Regional Cooperatives and the Domestic OpCos, and thus inherently implicates the Intercompany Transaction Regulations. Finally, the Regional Cooperative structuring was a transparent tax maneuver that failed to reflect the underlying economic interests of the entities involved.

In the years preceding the cooperative tax strategy, Parent's Procurement Division performed the duties later assumed by the National Cooperative. Under the cooperative tax strategy, the employees that had formerly worked within the Procurement Division began technically to work within the National Cooperative structure (though from their same desks used in the Procurement Division). The Cooperative assumed the contracts that had been negotiated by the Merchandising

[6] We note that the Taxpayer is not claiming deferral on the patronage dividend payments from the Regional Cooperatives to the Domestic OpCos, the transaction that, in form, clearly qualify as intercompany transactions.

Division and took over the task of negotiating purchase contracts. In years preceding the cooperative tax strategy, suppliers paid Earned Income to the Parent's Procurement Division, which included the value of the negotiated discounts, and the Procurement Division passed these amounts on to the Operating Companies via intercompany transactions. Under the cooperative tax strategy, the National Cooperative also received the benefit of the Earned Income negotiated,[7] but distributed such amounts to the Operating Companies (through the Regional Cooperatives) via patronage dividends.

During the years at issue, the National Cooperative conducted almost all of its business with the Domestic OpCos, and there is no evidence that the Parent anticipated that the National Cooperative would conduct significant business with the Foreign OpCos during those years. In spite of this fact, Parent created a structure in which the majority of the voting interest in the National Cooperative was put in the hands of the Foreign OpCos, whose dealings with the National Cooperative could be characterized as de minimis, relative to the volume of its business with the Domestic OpCos.

Analysis of the Promoter presentations makes clear that this exclusion of the National Cooperative from the Taxpayer consolidated group was not a by-product of a business-driven structuring, but rather a key component of a plan whose goal was tax savings. The Promoter presentations did not analyze or suggest business efficiencies or goals. The focus was tax savings, and achieving those tax savings by creating and utilizing a wholly-owned, but non-consolidatable cooperative that would take over functions then-currently being provided within the Taxpayer consolidated group. The Promoter presentations provide detailed instructions about how to prevent inclusion of the National Cooperative in the Taxpayer consolidated group. The presentation materials then explain how patronage dividends could be used to defer net income inclusion, assuming that the patronage dividends did not constitute intercompany transactions.

These tax motivations clearly drove the implementation of the cooperative tax structure. To the extent that bona fide, non-tax motivations for the cooperative structuring existed,[8] they clearly were pre-dated by the Promoter presentations. In Taxpayer's internal memoranda cited above, the Taxpayer's officers consistently refer to the idea presented by the Promoter as the "Coop Tax Project." Further, these memoranda make clear that there was to date no adequately developed business plan

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7 In some cases, the Earned Income was paid to the National Cooperative by the suppliers. In other cases, the Operating Companies paid full vendor list price to the National Cooperative, but the National Cooperative paid the negotiated discount price to the vendor. In those cases, the National Cooperative retained the amount of the negotiated discount until it paid the amount back to the Operating Companies via patronage distributions.

8 As noted above, the Taxpayer maintains that it sought to increase incentives for the OpCos to purchase centrally, to centralize accounts payable transactions, to promote cost savings in warehousing and transporting inventory, to protect Parent from regulatory enforcement, and to promote tax savings. These goals appear to be not related to the formation of a non-consolidatable cooperative.

associated with the cooperative tax project, and that it was probable that the Taxpayer had not even investigated the possible return on investment with regard to the structuring.

As discussed above, the strategy relies on the ability to exclude the National Cooperative from the Taxpayer consolidated group, and thus render inapplicable the single-entity principles of the intercompany transaction regulations. The chosen method of engineering this exclusion was the interposition of the Regional Cooperatives between the Domestic OpCos and the National Cooperative. Yet, during the years at issue, the Regional Cooperatives acted as pass-through entities, conducting no substantial business operations.[9] Had each Domestic OpCo held direct membership in the National Cooperative, members of the Taxpayer Consolidated Group would have easily held sufficient voting power to meet the requirements of section 1504(a)(2).

Although the Cooperative Tax Structuring was engineered to ensure that the patronage dividends from National Cooperative would not qualify as intercompany transactions, the structuring does rely on the occurrence of certain intercompany transactions. In form, the patronage dividends from the National Cooperative to the Regional Cooperatives were non-intercompany transactions. However, the succeeding patronage distributions from the Regional Cooperatives (which were included in the Taxpayer consolidated group) to the Domestic OpCos clearly were intercompany transactions which were required in order to route patronage dividends back to the Domestic OpCos, and thus qualify the National Cooperative for the benefits of Subchapter T. Thus, the cooperative tax project seeks to make use of intercompany transactions and while at the same time avoiding intercompany transaction treatment in order to achieve its deferral purposes.

Because the cooperative tax project was engaged in with a principal purpose to avoid the purposes of the intercompany transaction regulations, adjustments will be made to carry out the purposes of the intercompany transaction regulations. Given the facts presented, particularly the obviously tax-driven interjection of the Regional Cooperatives into the structuring, the National Cooperative will be treated as a member of the Taxpayer's consolidated group, and the patronage dividends from the National Cooperative will be treated as intercompany transactions. Therefore, as discussed above, application of §1.1502-13(c)(2)(ii) should result in the cooperative's taking into account its deduction in the same year in which the patron includes the patronage dividend in income. The inclusion of the two, completely offsetting items in a single taxable year would result in the same net outcome to the group that would have resulted if S and B were divisions of a single corporation (no net income or deduction). As a result, the Taxpayer consolidated group will take into account its net cost of goods

[9] Even if Regional Cooperative A were conducting operations sufficient to have its existence respected in the years at issue, sufficient voting power would remain in the hands of Regional Cooperative A and the other members to the Taxpayer consolidated group (not including members of Regional Cooperative A) to cause the National Cooperative to be includable in the Taxpayer consolidated group.

from suppliers, rather than overstating such cost and thus understating its consolidated taxable income.[10]

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Please call (202) 622-7530 if you have any further questions.

[10] The intercompany transaction rules will have no effect on the computation of the National Cooperative's income with regard to its transactions with the Foreign OpCos.