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subject:

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Corporation X =
Promoter =
Strategy =
Cooperative =
Subsidiary 1 =
Subsidiary 2 =
Subsidiary 3 =
City 1 =
State 1 =
State 2 =
P2 =
P3 =
b =

c =
d =
e =
f =
i =
j =
k =
l =
m =
n =
oo =
p =
q =
r =
s =
Month A =
Month B =
Month C =
Year 1 =
Year 2 =
Business A =
Business B =
Business C =
Business D =
Tax A =
Amount A =
Asset A =
Asset B =
Product A =

ISSUE

Whether Reg. § 1.1502-13(h), an anti-abuse provision, applies to the patronage dividends paid by the Cooperative to its member-patrons so that the Cooperative will not be able to deduct the amount of the patronage dividends until such dividends are taken into income by its member-patrons.

CONCLUSION

The payment of patronage dividends by the Cooperative to its member-patrons, who are all members of Taxpayer's consolidated group, is an intercompany transaction to which the rules of Reg. § 1.1502-13 apply. Reg. § 1.1502-13(h), an anti-abuse provision, applies to the patronage dividends paid by the Cooperative to its member-patrons to prevent the Cooperative from deducting the patronage dividends it pays until such dividends are taken into income by its member-patrons.

FACTS[1]

Corporation X, a publicly-traded company, is the parent company of a group of affiliated companies and owns directly or indirectly significant interests in certain partnerships. Corporation X was formed in Year 1 and is currently headquartered in City 1, State 1. Corporation X is also the common parent of the Corporation X and Subsidiaries consolidated group. (Taxpayer's consolidated group will sometimes hereinafter be referred to as "Taxpayer" and at other times as "the Taxpayer Group").

The Taxpayer Group is a large retailer that has many stores spanning many states with stores that include lines of business in the Business A, Business B, Business C, and Business D.

Prior to Month C, Year 2, Corporation X's General Office in City 1, State 1, was responsible for certain procurement and merchandising ("P&M") functions for the Taxpayer Group, such as negotiating and maintaining certain large nationwide contracts. Taxpayer also maintained *e* regional P&M divisions, which were segmented geographically, each having a headquarters office located in its specific region. Additionally, each of the Taxpayer Group's retail stores was responsible for its own P&M of goods unique to its geographic location. All P&M functions for the Taxpayer Group were performed by the P&M employees of either Company X or certain subsidiary-members of the Taxpayer Group.

In Month A, Year 2, Promoter approached Company X with a promotional Strategy, which, in part, advocated the formation of a cooperative. Promoter suggested to Company X that implementation of the cooperative-piece of the Strategy could reduce state and federal income taxes by avoiding certain state taxes and by deferring the inclusion of taxable income on the federal consolidated return.

Promoter's promotional materials identified three reasons for forming a cooperative; all involved avoiding state and/or federal income taxes. The materials specifically identify "the potential for federal deferral if the Cooperative is outside of the consolidated group."

Sometime around the end of Month B, Year 2, the Taxpayer signed Promoter's engagement letter and paid Promoter to provide consulting services with regard to the design and implementation of the cooperative-piece of the Strategy. Taxpayer did not ask Promoter or anyone else to provide it a letter expressing an opinion as to the business efficiency or viability of forming and operating a cooperative.

Acting in furtherance of the cooperative-piece of the Strategy, Taxpayer formed the Cooperative by incorporating it under the laws of State 1 in Month C, Year 2. The

[1] The facts set forth in the "Facts" section of this document are based on material submitted by e-mails to the Office of Chief Counsel (Corporate). Additional facts were provided in telephone conversations that occurred subsequent to the initial e-mail submissions.

Cooperative initially issued *r* shares of stock, one each to Corporation X, *s* subsidiary-members of the Taxpayer Group and *l* partnerships related to Corporation X. All *l* partnerships were owned by two or more subsidiary-members of the Taxpayer Group. *i* of the *s* subsidiaries were subsequently merged out of existence and their member shares in the Cooperative were cancelled. Currently, there are *s* shares of Cooperative's stock outstanding, one each held by Corporation X, *k* subsidiary-members of the Taxpayer Group and *l* partnerships related to Corporation X. At all times, no party unrelated to the members of the Taxpayer Group has held shares in the Cooperative or transacted business with the Cooperative on a patronage basis. At the time of its formation and at all times thereafter, the Cooperative has had a sufficient number of members that are partnerships so that the Cooperative was precluded from joining in the filing of a consolidated return with the members of the Taxpayer Group.

Of the *l* partnerships that are currently members of the Cooperative, *m* partnerships pre-existed the formation of the Cooperative. P3, the other partnership, was formed at the same time as the Cooperative to serve as a member. P3 serves as a patron for *n* subsidiary members of the Taxpayer Group, all *n* are located in State 2. P3 serves as a conduit for the P&M requirements of the *n* State 2 subsidiaries.

In implementing the Cooperative-piece of the Strategy, Corporation X transferred certain P&M employees to the Cooperative and constructed a building in City 1 to provide work space for those employees. These employees function as they have always functioned: currently they perform P&M services on behalf of the Cooperative's members; previously, they performed the same P&M services on behalf of subsidiary-members of the Taxpayer Group.

Prior to the formation of the Cooperative, the Taxpayer Group's P&M functions were conducted at three levels: (1) the Corporation X's General Office in City 1, State 1, was responsible for certain P&M functions for the Taxpayer Group, negotiating and maintaining certain large nationwide contracts (the "National" level); (2) *e* regional P&M divisions, which were segmented geographically (the "Regional" level), and (3) each of the Taxpayer-owned stores was responsible for its own P&M of goods unique to its geographic location (the "Local" level).

After the formation of the Cooperative, the P&M functions previously performed at the National and Regional levels, either by Corporation X or the Regional P&M offices, are now performed by the Cooperative. The patrons of the Cooperative, i.e., those members of Taxpayer who transact business with the Cooperative, are essentially the same members that utilized Taxpayer's P&M function prior to the formation of the Cooperative.[2]

[2] A few other subsidiary-members of the Taxpayer Group also utilized Taxpayer's P&M function immediately prior to the formation of the Cooperative. Those subsidiary-members are not now patrons of the Cooperative because they have since merged into other subsidiary–members of the Taxpayer's Group. The surviving subsidiary-members are patrons of the Cooperative.

The Taxpayer transferred certain P&M employees from the General Office and from Regional P&M divisions to the Cooperative, and the Cooperative took over certain P&M functions previously performed by the National, Regional and Local P&M divisions and offices.

One of the Cooperative's business purposes is to negotiate contracts with third-party vendors on behalf of its members. The Cooperative does not have either physical or implied custody or responsibility for any purchasing contract. The Cooperative simply negotiates the contract for the patrons. If there is additional related work to do on a pre-existing contract (a contract that was entered into prior to the formation of the Cooperative), the Cooperative will do the additional work on these pre-existing contracts but will not take ownership of them.

Moreover, the Cooperative neither takes title to nor delivery of the merchandise procured. The Cooperative neither pays for merchandise procured from the third party vendors, nor warehouses such merchandise. The warehousing function is done, at least in part, by P2. The members pay the third party vendors directly for any merchandise delivered to them or to the warehouses. The Cooperative charges its members a *p*% surcharge on all purchases made by such members to compensate the Cooperative for the P&M functions.

The Cooperative's other business purpose is to engage in employee leasing. Employees of certain stores located in certain states were transferred from these stores to the Cooperative. The Cooperative leases these employees back to the same stores for *oo*% of the sum of the employees' payroll, payroll taxes, pension contributions, and employee benefits. No change in the job performance or duties of these employees resulted from the change of employer. These employees remain in the stores from which they were transferred. The only noticeable changes resulting from the transfer of the store employees to the Cooperative are that they now work for the Cooperative. The stores from which they were transferred pay their salaries and bill the Cooperative for the payment amount.

The Cooperative charges members a *q*% upcharge for the leasing of employees. The Cooperative's employee-leasing business function furthers one of the three goals promoted by the Promoter: i.e., avoidance of certain state taxes in certain states.

Taxpayer asserts that it anticipates receiving the following four benefits from implementing the cooperative-piece of the Strategy:

1. Reducing state Tax A taxes in certain states;

2. Saving money by eliminating roughly *b* jobs[3];

[3] Actually, it has been determined that the Taxpayer, in implementing the Strategy, terminated about *c* P&M employees but hired *d* P&M employees.

3. Maximizing its economies of scale by locating the Cooperative in City 1, State 1; and

4. Obtaining a 1-year deferral of recognizing federal taxable income.

Taxpayer claims that benefit #1 listed above was its main incentive for establishing the cooperative structure.

In further support of its decision to form the Cooperative, Taxpayer argues that centralization of its procurement functions would achieve significant cost reductions and that the procurement of items under National contracts may permit it to achieve greater price discounts than under its Regional P&M system. Taxpayer points to Subsidiary 1, which according to Taxpayer, achieved significant benefits from the centralized P&M of Product A products, and that Taxpayer's management determined that Taxpayer may also recognize significant benefits if Subsidiary 1's centralized process could be utilized by Taxpayer for these items. To achieve these benefits, Taxpayer determined that it was necessary to operate the centralized P&M function in one entity.

Taxpayer also asserts that, in addition to increased profits from purchasing economies of scale, its consolidation of, not only its procurement function, but also of its distribution centers, will reduce the cost of its inventory and allow it to carefully manage the flow of inventory. This will result in the reduction of the working capital necessary to hold higher levels of inventory. Taxpayer anticipates that it will save Amount A of dollars as a result of the operational efficiencies created by centralizing the procurement function into a single entity.

LAW AND ANALYSIS

LAW

Code § 1504(a)(2) requires that, for a subsidiary to be included in a consolidated group, stock possessing (1) at least 80 percent of the total voting power of the stock of the corporation, and (2) a value equal to at least 80 percent of the total value of the stock of the corporation must be held by the parent corporation and/or other members of the consolidated group.

Reg. § 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). Reg. §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 Reg. §1.1502-13 are inconsistent with a member's otherwise applicable methods of accounting, the timing rules of Reg. §1.1502-13 control. S's or B's application of the timing rules of Reg. §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. Reg. §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. Reg. §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. Reg. §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. Reg. §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). Reg. §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. Reg. §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 Code § 382(h) or 384. Reg. §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 Reg. §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. Reg. §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. Reg. §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). Reg. §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. Reg. §1.1502-13(c)(1)(i).

Reg. § 1.1502-13(h)(1) provides an anti-avoidance rule, which states that "[i]f 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, to the extent that an entity taxable as a corporation markets, purchases, or performs other business functions for its patrons on a cooperative basis, the entity may avoid any federal income tax on otherwise taxable income by distributing its income to its patrons in compliance with the requirements of Subchapter T of the Code. Under Code § 1382(b), the entity ("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. Code § 1385. Thus, 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

If the cooperative and the patron are members of the same consolidated group, the timing rules of the intercompany transaction regulations would apply to ensure single entity treatment of the cooperative and patron. Under such circumstances, the payment of patronage dividends would qualify as intercompany transactions under the broad definition of that term. See Reg. §1.1502-13(b)(1)(i). Under the matching rule of the intercompany transaction regulations, 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. Reg. §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 Reg. §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. Reg. §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). Reg. §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 (the cooperative) to a second division (the patron) would have resulted in no net income or deduction to the corporation. Therefore, application of the matching rule should result in the cooperative 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 (as provided under the rules of Subchapter T) of income inclusion on the group's consolidated return, and would obtain a different outcome than is otherwise provided under the Code and regulations. This result is explicitly contemplated by the regulations, however. See e.g., Reg. §1.1502-13(c)(7)(ii), Ex. 5(e) (otherwise available installment reporting denied under single-entity principles); see also Reg. §1.1502-13(a)(3) (to the extent the timing rules of Reg. §1.1502-13 are inconsistent with a member's otherwise applicable methods of accounting, the timing rules of Reg. §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 patrons as a whole were able to take advantage of the rules of Subchapter T to gain deferral of tax on the consolidated return in an amount equal to the patronage dividend and benefit from what is essentially an interest free loan from the government, the group would be able to use an intercompany transaction (payment of the patronage dividend) to defer consolidated taxable income.

The Taxpayer, by transferring the store employees (the leasing function) and the P&M employees (the P&M function) to the Cooperative, consummated a transaction that produced abusive tax results. The following illustration demonstrates why the transferring of the P&M function to the "outside-of-the-Taxpayer-Group" Cooperative resulted in an abusive federal income tax result: Prior to the formation of the Cooperative, patrons (members of the Taxpayer Group) that utilized Taxpayer's National, Regional and/or local P&M functions incurred expenses primarily consisting of the cost of the items purchased and an allocable share of the wages paid to the P&M employees negotiating the underlying purchasing contract. In moving the P&M functions into the newly formed Cooperative, patrons utilizing the P&M function now are charged a *p*% surcharge, which includes, among other costs, an allocable share of the P&M employee wages. With the creation of the Cooperative as structured, the patrons receive essentially the very same services but at greater cost. Patrons pay directly to the third party supplier the cost of the items purchased, and pay to the Cooperative a surcharge; the surcharge includes the P&M employee wages. There is a differential between the *p*% surcharge and the allocable share of the P&M employee wages, and this differential is returned to the members in the payment period (essentially, the next tax year in the form of Patronage Dividends). This strategy artificially inflates the "cost of goods sold" of the Taxpayer Group in the earlier year, thereby providing members of the Taxpayer Group with an artificial reduction of income in the earlier year, the year the surcharge is paid. The Taxpayer Group pays less income tax in the earlier year, and includes the patronage dividends (i.e., the *p*% surcharge less an allocable share of the P&M employee wages) in a later year. This provides Taxpayer with an annual "interest-free loan" from the government in the amount of the patronage dividends. The abusive tax results are the same with regard to the employee leasing function of the Cooperative. In forming the Cooperative with an employee leasing function for the sole purpose of transferring "in-house" to the "out-of-the-Taxpayer-Group" Cooperative so that those employees would be leased back "in house," also resulted in the same artificial inflation in an earlier year of the Taxpayer Group's cost of goods sold, thereby decreasing the Taxpayer's income in the earlier year.

In summary, the Taxpayer Group (through the patrons) inflated their normal "cost of goods sold" by paying a surcharge (consisting of cost plus a mark-up) to the Cooperative, which provided P&M services to the members; the same services the members previously paid much less for. The Cooperative later returns to the patrons the surcharge (less the allocable portion of the P&M employee wages) and the patrons include this amount in their taxable income in the year of receipt. Therefore, economically, the Taxpayer Group as a whole, in the year in which they include the surcharge in their "cost of goods sold", has not truly borne an expense equal to the negotiated purchase price plus the *p*% surcharge. Yet, because of the status of the Cooperative and the fact that, within 8 ½ months following the end of its taxable year, the Cooperative will transmit the amount of the surcharge (less an allocable share of the

P&M employee wages) back to its patrons on a cooperative basis, application of the rules of Subchapter T would allow for deferral by the Taxpayer Group of tax on the group's consolidated return in an amount equal to the patronage dividend through the use of an intercompany transaction.

III. Application of the Anti-avoidance Rule to the Cooperative Structure

Taxpayer formed the Cooperative to be outside of the Taxpayer Group and it did so by the seemingly arbitrary interjection of P3 between the "natural" or "historical" patrons (who are all members of the Taxpayer Group) and the Cooperative. The interjection of P3 between the Cooperative and certain patron members of the Taxpayer Group prevents the Cooperative from being a member of the Taxpayer Group because it ensures that the members of the Taxpayer Group do not possess the shares of the Cooperative necessary to meet the required vote and value test of Code § 1504(a)(2). The Taxpayer's argument for forming the Cooperative outside the Taxpayer Group was not that it intended to avoid consolidation; rather, its intent was to streamline the purchasing process for all *n* State 2 patrons. The Taxpayer argues that the Cooperative was outside the Taxpayer Group as a consequence of the streamlining of its operations. The Taxpayer's argument seems unconvincing given that the partners of the P3 partnership continued to conduct business directly with the Cooperative such that they were the real patrons of the Cooperative.

As discussed above, the Taxpayer organized the Cooperative to have *s* members, all with equal voting rights. *n* of those members were members of the Taxpayer Group, whereas the remaining *l* were partnerships owned by members of the Taxpayer Group. Taxpayer argues that because the Cooperative does not meet the 80-percent vote and value test of section 1504(a)(2), it may not be included in the Taxpayer Group, and therefore the intercompany transaction regulations do not apply to transactions (i.e., Patronage Dividends) between the Cooperative and members of the Taxpayer Group. However, the anti-avoidance rule of Reg. §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.

Emphasis added.

Under the facts presented, the anti-avoidance rule of Reg. § 1.1502-13(h) applies. First, the Promoter's presentation stresses state tax savings and deferral of federal income taxes. Second, the Taxpayer lacks legitimate non-tax business reasons for forming the Cooperative outside of the Taxpayer Group. Third, all of the patrons are members of the Taxpayer Group; there are neither unrelated patrons nor non-group patrons. Fourth, the Taxpayer did not ask Promoter or anyone else to provide it a letter expressing an opinion as to the business efficiency or viability of forming and operating a cooperative. Fifth, the Taxpayer Group benefitted significantly from the one year tax deferral provided by Subchapter T of the Code.

The above 5 facts clearly demonstrate that Taxpayer pursued the cooperative-piece of the Strategy with a principal purpose of achieving deferral of taxation in the amount of the surcharge, less P&M employee wages, and the *q*% upcharge on the employee leasing (presumably also less employee wages). The cooperative structure enables Taxpayer to claim a cost of goods in excess of the sum of: (1) the negotiated purchase price; and (2) the allocable share of P&M employee wages. This artificial inflation of cost of goods sold is designed to shelter the Taxpayer's income. The Promoter's material, the Taxpayer's lack of relevant non-tax business reasons for interjecting P3 between the Cooperative and its patrons, and the substantial tax savings obtained from deferring the inclusion of income on the Taxpayer Group's consolidated return, show that avoidance of the application of the intercompany transaction rules (and thus the single-entity principles underlying them) to the patronage distributions from the Cooperative to members of the Taxpayer Group was a principal tactic underlying the implementation of the cooperative-piece of the Strategy. Further, the formation of the Cooperative so that at all times there would be a sufficient number of partnerships as members of the Cooperative was a transparent tax maneuver that failed to reflect the underlying economic interests of the entities involved.[4] P3, which was formed contemporaneously with the Cooperative, represents *n* subsidiary-members of the Taxpayer Group, all of whom transact business (purportedly through the partnership) with the Cooperative. Although Asset A and Asset B were contributed to P3 in order to make it appear to have a function separate from its role in the cooperative-piece of the Strategy, the transfer of Asset A and Asset B was just window dressing. The sole purpose of P3's formation and its interjection between these *n* subsidiary-members and the Cooperative was to prevent consolidation of the Cooperative.[5]

In the years preceding the formation of the Cooperative, the Taxpayer Group's three-tier P&M structure performed the same duties later assumed by the Cooperative. Under the cooperative-piece of the Strategy, the employees that had formerly worked at the National and Regional P&M levels, were transferred to the Cooperative to do the same work they had done previously. The Cooperative negotiated the contracts that had already been negotiated by the National Office and the Regional P&M divisions. Prior to the Cooperative's formation, a principal expense of the subsidiary-members of the Taxpayer Group utilizing the Taxpayer Group's P&M functions was an allocable share of the P&M employee wages. The National and Regional P&M levels passed

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[4] Initially, there were *r* members, of which *l* were partnerships. Currently, there are *s* members, of which *l* are partnerships. From its inception, there were a sufficient number of partnerships holding member interests in the Cooperative, thereby preventing consolidation of the Cooperative.
[5] The partners of P3 contributed property (Asset A and/or Asset B), cash or both for their P3 partnership interests. On its tax returns, P3 reported rental income and depreciation expenses. On P3's books, however, P3 reported no rental income, no land, no depreciable assets, and no depreciation expenses.

employee wage expenses on to the utilizing subsidiary-members via intercompany transactions. Currently, the Cooperative not only passed on an allocable share of the P&M employee wages (i.e., the "cost" element of the surcharge) to its members, but also bills its members a mark-up fee for its services. The Cooperative later distributes the surcharge amount (less allocable share of the P&M employee wages) to its members (directly to some, and through partnerships to others) via patronage dividends.

An analysis of the Promoter presentation makes clear that the purposeful exclusion of the Cooperative from the Taxpayer 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 presentation did not analyze or suggest business efficiencies or goals. Nor did the Taxpayer seek from the Promoter or anyone else analysis of the business efficiencies of implementing a Cooperative structure. The Taxpayer's focus was tax savings, and achieving those tax savings by creating and utilizing a non-consolidatable cooperative that would take over functions then currently being provided by offices and divisions within the Taxpayer Group. The Promoter's presentation materials revealed to the Taxpayer how the patronage dividends can be used to defer net income inclusion if the cooperative was not a member of the federal consolidated return.

These tax motivations clearly drove the implementation of the Cooperative structuring. To the extent that bona fide, non-tax motivations for the Cooperative structuring existed, based on the material reviewed these non-tax motivations appear to be pre-dated by the Promoter presentations: i.e., Taxpayer did not ask Promoter or anyone else to provide it a letter expressing an opinion as to the business efficiency or viability of forming and operating a Cooperative.

As discussed above, the strategy relies on the ability to exclude the Cooperative from the Taxpayer Group, and thus render inapplicable the single-entity principles of the intercompany transaction regulations. The chosen method of engineering this exclusion was the contemporaneous formation and interposition of P3 between the *n* State 2 patrons and the Cooperative. Yet, during the years at issue, P3 acted as pass-through entity, and conducted no substantial business operations. Had each of the *n* State 2 patrons held a direct membership the Cooperative, the subsidiary-members of the Taxpayer Group would have held sufficient voting power to meet the requirements of section 1504(a)(2).[6]

[6] As stated above, P3 is the Cooperative's patron on behalf of the *n* State 2 subsidiary-members of the Taxpayer Group. Historically, the P&M functions for all State 2 subsidiary-members have been performed by the P&M departments of Subsidiary 2 and Subsidiary 3. Former P&M officials of Subsidiary 2 and Subsidiary 3 are now employees of P3. These individuals are responsible for overseeing the P&M functions for the State 2 subsidiary-members by working directly with the Cooperative. We note that if Taxpayer had maintained its historical practice of having P&M employees of Subsidiary 2 and Subsidiary 3 act on behalf of the *n* State 2 subsidiary-members, the Cooperative's membership would number *f*; *m* of the *f* would be the pre-existing partnerships. If that were the case, the Cooperative would be a member of the Taxpayer Group.

The cooperative-piece of the Strategy seeks to avoid intercompany transaction treatment in order to achieve its deferral purposes. Because the cooperative-piece of the Strategy 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 formation and interjection of P3 into the cooperative structuring, the Cooperative will be treated as a member of the Taxpayer Group, and the patronage dividends the Cooperative distributed to the members will be treated as intercompany transactions. Therefore, as discussed above, application of Reg. §1.1502-13(c)(2)(ii) should result in the Cooperative taking into account its deduction in the same year in which the patrons include 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 Group will take into account its net cost of goods from suppliers, rather than overstating such cost and thus understating its consolidated taxable income.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

N/A

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Please call (202) 622-7930 if you have any further questions.

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