Office of Chief Counsel
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Memorandum

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to:
Case Manager
(Large & Midsize Business)

from: Marie C. Milnes-Vasquez
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subject:

LEGEND

Taxpayer =

Cooperative =

Patron 1 =

Patron 2 =

Patron 3 =

Patron 4 =

Patron 5 =

Products & Services =

Year 1 =

Date 1 =

Date 2 =

ISSUE

Whether the Intercompany Transaction Matching Rule of §1.1502-13(c)(2) applies to ensure that Cooperative and Patrons take into account in the same taxable year their items from the intercompany transactions at issue.

CONCLUSION

The Intercompany Transaction Matching Rule of §1.1502-13(c)(2) does apply to ensure that Cooperative and Patrons take into account in the same taxable year their items from the intercompany transactions at issue. As a result, Cooperative will defer taking into account its deduction for patronage dividends until the year in which Patrons take into account their corresponding items of income.

FACTS

I. In General

Taxpayer (Parent) is the common parent of an affiliated group of corporations (Parent Consolidated Group) that files a consolidated Federal income tax return under an accrual method of accounting. The primary business of the group is to manufacture and sell Products and Services to domestic and foreign markets. The Parent Consolidated Group is under audit for taxable years ended Date 1 and Date 2.

Cooperative was organized in Year 1 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. Since its organization, Cooperative has conducted most of the Parent Consolidated Group's manufacturing and procurement operations. Parent and each of Patron 1, Patron 2, Patron 3, Patron 4 and Patron 5 (collectively "the Patrons") were patrons of Cooperative in the years at issue. Each of the Patrons is a member of the Parent Consolidated Group.

II. Taxpayer's Reporting Position

Taxpayer takes the position that Cooperative is taxable as a cooperative under Subchapter T.[1] Taxpayer further takes the position that, notwithstanding the fact that Cooperative and each of its Patrons are members of the Parent Consolidated Group,

[1] This memorandum assumes that this legal conclusion is accurate. Should Cooperative not qualify to be taxed as a cooperative under Subchapter T, the intercompany transaction issue presented herein becomes moot.

the Cooperative and the Patrons should be entitled to report their items that flowed from the intercompany patronage dividends at different times: Cooperative should be entitled to a deduction under section 1382 in the taxable year before the patronage dividend was paid, but, under section 1385 and the regulations thereunder, the Patrons should not include an equivalent amount of income until the year of the payment. The Taxpayer did not apply the intercompany Matching Rule of § 1.1502-13(c) to override the result provided under Subchapter T. As a result, the Cooperative deducted its patronage dividend amounts one year before the Patrons included such patronage dividends in income.

LAW AND ANALYSIS

LAW

I. Subchapter T

Section 1382(b) provides, in pertinent part:

> In determining the taxable income of a [cooperative], there shall not be taken into account amounts paid during the payment period for the taxable year—
> (1) as patronage dividends (as defined in section 1388(a)) * * * *
>
> For purposes of this title, any amount not taken into account under the preceding sentence shall, in the case of an amount described in paragraph (1) or (2), be treated in the same manner as an item of gross income and a deduction therefrom * * * *

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).

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. 82-51, 1982-1 C.B. 117.

In addition, certain additional factors are considered in determining whether a taxpayer qualifies 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.

II. Consolidated Return Rules

Section 1502 provides:

> The Secretary shall prescribe such regulations as he may deem necessary in order that the tax liability of any affiliated group of corporations making a consolidated return and of each corporation in the group . . . may be returned, determined, computed, assessed, collected, and adjusted, in such manner as clearly to reflect the income tax liability and the various facts necessary for the determination of such liability, and in order to prevent the avoidance of such tax liability. In carrying out the preceding sentence, the Secretary may prescribe rules that are different from the provisions of chapter 1 that would apply if such corporations filed separate returns.

The final sentence of section 1502 was added to the statute in 2004. However, it is applicable retroactively to all years. See 108 P.L. 357, §844(c); 118 Stat. 1418 ("This section, and the amendment made by this section, shall apply to taxable years beginning before, on, or after the date of the enactment of this Act.").

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).

Section 1.1502-13(a)(2) provides:

> Separate entity and single entity treatment.—The selling member (S) and the buying member (B) are treated as separate entities for some purposes but as divisions of a single corporation for other purposes. The *amount* and *location* of

> S's intercompany items and B's corresponding items are determined on a separate entity basis (separate entity treatment). * * * The timing, and the character, source, and other attributes of the intercompany items and corresponding items, although initially determined on a separate entity basis, are redetermined under this section to produce the effect of transactions between divisions of a single corporation (single entity treatment). For example, if S sells land to B at a gain and B sells the land to a nonmember, S does not take its gain into account until B's sale to the nonmember.

Section 1.1502-13(c)(3) provides that, as divisions of a single corporation, S and B are treated as engaging in their actual transaction and owning any actual property involved in the transaction. Further, although they are treated as divisions, S and B nevertheless are treated as having any special status that they have under the Code or regulations.

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 was 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).

The principal rule 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(c)(5) discusses the application of the Matching Rule to intercompany transactions involving so-called Special Status Entities. That section provides:

> Notwithstanding the general rule of paragraph (c)(1)(i) of this section [Application of the Matching Rule to attributes], to the extent an item's attributes determined under this section are permitted or not permitted to a member under the Internal Revenue Code or regulations by reason of a member's special status, the attributes required under the Internal Revenue Code or regulations apply to that member's items (but not to the other member). * * *

The regulations exempt certain intercompany transactions from application of the Matching Rule. See § 1.1502-13(e)(i) (providing for bank and thrift group members to increase or reduce their reserves on a separate entity basis); § 1.1502-13(e)(ii) (providing for separate entity reporting of intercompany direct insurance transactions, but emphasizing that intercompany reinsurance transactions are subject to the Matching Rule).

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. §1.1502-13(a)(3). 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. Id. 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. Id.

Section 1.1502-80 provides that "[t]he Internal Revenue Code, or other law, shall be applicable to the [consolidated] group to the extent the regulations do not exclude its application."

ANALYSIS

I. Cooperative Rules in General

In general, as described 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, because Cooperative (S) and Patron (B) are members of the same consolidated group, the timing rules of the intercompany transaction regulations apply to ensure single entity treatment of the combined Cooperative and Patron. Application of these rules ensures a clear reflection of the tax liability of the group as a whole, as required by section 1502.

Because Cooperative and Patrons are members of the same group, the payment of patronage dividends qualifies as an intercompany transaction under the broad definition of that term. See §1.1502-13(b)(1)(i). Application of the Matching Rule of the intercompany transaction regulations ensures that the intercompany item of S (the deduction of Cooperative) is taken into account in the same taxable year as the corresponding item of B (the income of Patron), which is 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 own, separate entity accounting method. §1.1502-13(c)(2)(i). Because each Patron is B in the transactions at issue, the application of the rules of subchapter T to the receipt by the Patrons of the patronage dividends is unchanged, and the Patrons must include such amounts in income in the year of receipt. However, under the timing rule, S (Cooperative) will 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 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 results 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 will result in the same net outcome to the group that would have resulted if S and B had been divisions of a single corporation (no net income or deduction).

Application of this timing rule results in Cooperative taking into account its patronage deduction (its intercompany item) one year later than generally required outside of consolidation, under section 1382(b). Parent Consolidated Group will not be able to take advantage of the deferral provided under the rules of subchapter T with regard to its intercompany transactions. This is admittedly a different outcome than would obtain if Cooperative had not been a member of Parent Consolidated Group.

This type of outcome was explicitly contemplated by Congress in authorizing the consolidated return regulations. In section 1502, Congress charged the Secretary with promulgating regulations to ensure clear reflection of income of each member of the group and the group as a whole. In doing so, the Secretary has express congressional blessing to "prescribe rules that are different from the provisions of chapter 1 that would apply if such corporations filed separate returns." Further, the regulations provide explicit examples of cases in which otherwise applicable accounting methods are overridden by application of the Matching Rule. 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). Indeed, the Matching Rule has impact on members' reporting of their items only in those cases in which the single entity outcome differs from the separate entity outcome that would result outside of the group. See, e.g., §1.1502-13(c)(7)(ii), Ex. 8 (no redetermination of attributes or timing where separate entity and single entity outcomes are identical) and Ex.14 (same).

Further, this outcome is consistent with the stated purpose of the intercompany transaction rules, which 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)." Section 1.1502-13(a)(1). To the extent that Cooperative and its Patrons as a whole were able to take advantage of the rules of subchapter T, the group would be able to use an intercompany transaction (payment of the patronage dividend) to defer

consolidated taxable income equal to the patronage dividend through the use of an intercompany transaction.

III. Responses to Taxpayer's Arguments

Based on application of the Special Status rule of §1.1502-13(c)(5) and legislative intent, Taxpayer argues that the Matching Rule of section §1.1502-13(c)(2) does not apply to cause Cooperative to take into account its intercompany items in the same year as Patrons take into account their corresponding items that flow from the same intercompany transactions. These arguments have no merit.

A. Technical Arguments – Special Status

Taxpayer argues that, based on the Special Status rule of §1.1502-13(c)(5), Cooperative and Patrons should be able to report their items from the same intercompany transactions in different taxable years. Section 1.1502-13(c)(5) provides:

> Notwithstanding the general rule of paragraph (c)(1)(i) of this section [Application of the Matching Rule to attributes], to the extent an item's attributes determined under this section are permitted or not permitted to a member under the Internal Revenue Code or regulations by reason of a member's special status, the attributes required under the Internal Revenue Code or regulations apply to that member's items (but not to the other member). * * *

As discussed above, "attribute" is specifically defined within the intercompany transaction rules as "all of the [intercompany or corresponding] item's characteristics, except amount, location, and timing, 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).

The issue in this case is whether the Cooperative and its Patrons must match the timing of the reporting of their items. As noted above, §1.1502-13(c)(5) provides that the attributes of items of Special Status entities are exempted from application of the Matching Rule. However, timing is explicitly excluded from the definition of "attribute". Thus, the timing of the reporting of Cooperative and Patron items remain subject to the Matching Rule.

Taxpayer appears to concede that, if the Matching Rule applies to the timing of the items in question, Cooperative and Patrons must take their items into account in the same taxable year. Further, Taxpayer clearly concedes that, under the Special Status rule of §1.1502-13(c)(5), only "attributes" of an intercompany or corresponding item of a

special status entity are exempted from redetermination under the Matching Rule.[2] Taxpayer's arguments go to the putative qualification of the timing of Cooperative's items as an "attribute" that is exempt from the Matching Rule.

1. Exclusion vs. Deduction

Taxpayer argues:

> The patronage dividends at issue meet the definition of the term "attribute" because section 1382(b) provides that patronage dividends paid during the proper payment period "shall not be taken into account" (*i.e.*, is excluded from gross income), to determine the taxable income of a cooperative.[3]

Taxpayer appears to be relying on the fact that the regulation provides that the treatment of an item as excluded from gross income is an attribute of that item. See §1.1502-13(b)(6). Thus, Taxpayer's first argument depends upon Cooperative's tax benefit under Subchapter T constituting an exclusion rather than a deduction. However, contrary to Taxpayer's claim, section 1382(b) explicitly provides that, for purposes of the Internal Revenue Code, the amount of any patronage dividend will "be treated in the same manner as an item of gross income and a deduction therefrom." Therefore, Taxpayer's claim is facially unsupportable and does not merit further discussion.

2. Special Status Assuming Cooperative's Item is a Deduction

Taxpayer next argues that, even if the Cooperative's intercompany item does constitute a deduction, the timing of such item should be treated as an "attribute" for purposes of the intercompany transaction rules. This argument is also without merit.

The intercompany transaction regulations are a tightly-drafted set of rules, which are based on well-defined principles. The purposes of the regulations are carried out based on the application of closely-crafted definitions. As discussed above, "attribute" is specifically defined within those regulations as "all of the [intercompany or corresponding] item's characteristics, except amount, location, and timing, necessary to determine the item's effect on taxable income (and tax liability)."

Thus, the regulations expressly exclude timing from the definition of an "attribute." Although the Taxpayer argues for an exception from this definition to be made in the case of a Special Status entity, the regulation's specific use of the term "attribute" in defining the exemption from application of the Matching Rule indicates an

[2] See Protest p.18.
[3] Protest p.19.

adoption of the precise definition contained in the regulations.[4] Further, § 1.1502-13(c)(5), the special status rule on which the Taxpayer relies, specifically operates to "turn off" application of §1.1502-13(c)(1)(i), the provision governing the matching of attributes defined in §1.1502-13(b)(6). The special status rule of §1.1502-13(c)(5) has no applicability to §1.1502-13(c)(2), the rule that applies matching principles to govern the timing of the reporting of member's items.

Further, the drafters of the regulations clearly understood how to wholly exempt from the Matching Rule certain transactions of special status entities. They did so with regard to a number of transactions involving special status entities, but not all. See, e.g., § 1.1502-13(e)(i) (providing for bank and thrift members of a group to increase or reduce their reserves on a separate entity basis); § 1.1502-13(e)(ii)(A) (providing for separate entity reporting of intercompany direct insurance transactions). Under these provisions, members are authorized to report the specifically-identified transactions on a separate entity basis. There is no equivalent rule for cooperatives.

Also noteworthy is § 1.1502-13(e)(ii)(B), which provides that, although direct insurance transactions between insurance companies and other consolidated group members are exempted from the Matching Rule, intercompany reinsurance transactions by those same insurance companies are subject to the Matching Rule. Those member insurance companies are clearly special status entities for which Congress created specialized and highly complex rules. However, §1.1502-13(e)(ii) makes clear that the Matching Rule is applicable to insurance companies, except with respect to the direct insurance transactions specified in §1.1502-13(e)(ii).

B. Legislative Intent

All of Taxpayer's technical arguments appear to be fueled by its position that the Legislative intent behind the subchapter T rules may not be overridden by application of the intercompany transaction regulations. Taxpayer notes Congress specifically sanctioned the timing mismatch provided under subchapter T. Taxpayer concludes that "the Matching Rule should only be used to prevent a taxpayer from using intercompany

[4] Taxpayer challenges whether the regulation's exclusion of timing from the definition of attribute is absolute. To this end, Taxpayer notes that the Special Status rule of §1.1502-13(c)(5) names the section 1503(c) limitation on absorption of certain losses as a "special status issue". See Protest p.19.

The reference to the section 1503(c) limitation does not call into question whether timing is excluded from the definition of attribute. Section 1503(c) does not affect the timing under which a member takes items into account (essentially causing the income, deduction, gain and loss items to be reported by the group on its consolidated return). Rather, it has impact only after a member's item have been taken into account and have resulted in the reporting of a loss. Section 1503(c) then limits the group's ability to offset certain losses against income of certain other members, and is somewhat analogous to a section 382 limitation.

transactions to gain an impermissible tax advantage not available to non-consolidated parties."[5]

The Taxpayer is wrong. Although Congress sanctioned a timing mismatch between cooperatives and their patrons, as discussed above, through section 1502, Congress specifically charged the Secretary with promulgating regulations to ensure clear reflection of income of members of a group and the group as a whole. Congress gave the Secretary explicit and retroactive permission to "prescribe rules that are different from the provisions of chapter 1 that would apply if such corporations filed separate returns." As discussed in detail above, application of the Matching Rule to achieve single entity treatment of Cooperative and Patrons ensures clear reflection of income and is clearly sanctioned by Congress under section 1502.

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

[5] Protest p.18.