AHC COOPERATIVE TAXATION BRIEF

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In a July 2012 Chief Counsel Advisory (CCA), the Service considered whether cooperatives and their patrons are subject to the related-party rules under Section 267.

Background

Taxpayer was parent of consolidated group consisting of domestic and foreign subsidiaries of multiple tiers. At some point, Taxpayer sought to implement a tax strategy that involved the use of a Subchapter T cooperative (Cooperative) to receive and operate manufacturing assets. The assets were transferred out of the consolidated group and into Cooperative. In addition, Cooperative redeemed previously issued shares and issued new shares so that each subsidiary owned one share each in Cooperative. Upon completion of the strategy, Cooperative was no longer a member of the consolidated group but was a member of the controlled group (as defined in Section 267(f)).

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As a result of Taxpayer's tax strategy, Cooperative deducted patronage dividends to patrons in the year of patronage, but they did not report income until the subsequent tax year when the payment was received.

Related-Party Rules of Section 267

In certain circumstances, I.R.C. § 267 limits the deduction of losses in transactions, directly or indirectly, between related persons. It also postpones deductions arising from payments to related parties until the related party recognizes income from the payment, as long as the mismatch arises from differences in accounting methods. In effect, the rule imposes the matching principle among related parties. Moreover, Section 267 and its regulations specifically address the matching rule

with regard to payments to foreign persons, including controlled foreign corporations, known as CFCs.

Read a prior Cooperative Tax Brief regarding a global cooperative.

How Does Section 267 Apply to Cooperatives' Patronage Dividends?

The primary issue addressed by the CCA was the timing of Cooperative's deduction for patronage dividends paid to its related-party patrons. The problem of interpretation arose because of the intersection of Subchapter T and Section 267.

Under Subchapter T, a cooperative can generally deduct patronage dividends paid in the year of patronage, as long as they are paid within 8 1/2 months after the close of the tax year. On the other hand, patrons generally recognize income, if any, arising from the patronage dividend when received. Thus, Subchapter T inherently accepts some mismatching of income and deduction from patronage dividends.

As noted above, however, Section 267 generally requires a matching of income and deduction in transactions between related parties. The CCA seems to side with the matching rule of Section 267 for patronage dividends to related-parties. In other words, Section 267 "requires related persons to use the same accounting method with respect to transactions between themselves in order to prevent the allowance of a deduction without the corresponding inclusion in income." Finally, the CCA addressed the rules concerning Cooperative's foreign patrons. It concluded that, unless one of the special exceptions applied, Cooperative must delay its deduction until its foreign patrons reported patronage dividends as income.

Alternative Basis: Patronage Dividends Were Intercompany Sales

As an alternative basis, the CCA concluded that patronage dividends were

"intercompany sales" among members of a controlled group. Under the Section 267(f), deductions arising from the patronage dividends are deferred until the related-parties recognize income from them. Accordingly, Cooperative must defer its patronage-dividend deduction until its patrons recognize income from them.

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Conclusion

The CCA illustrates one of the benefits of Subchapter T. At the same time, it demonstrates how Subchapter T intersects with two other tax regimes that limit those benefits. Section 267 limits the tax strategies arising from related-party transactions. And U.S. international tax rules limit taxpayers' ability to "inappropriately" shift income to low-tax foreign jurisdictions or otherwise use foreign entities to lower U.S. taxes.

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