


Transfer Pricing Thoughts: North America

By Patricia G. Lewis and Matthew W. Frank

Thoughts on Cooperatives

In an earlier issue of this *Journal*, we discussed transfer pricing issues relating to joint ventures.[1] In this column, we turn our focus to a kindred issue – the transfer pricing treatment of cooperatives. Though a cooperative and a joint venture may be substantially similar in both organization and operation, their treatment under the transfer pricing rules is strikingly different.

Transfer Pricing Immunity

Unlike joint ventures, cooperatives (as defined below) are effectively immune from the transfer pricing rules of Code Sec. 482. The IRS has conceded it does not have authority under Code Sec. 482 to allocate income between a cooperative and its member/patrons. This view was spelled out in a 1980 General Counsel Memorandum wherein the IRS examined a case involving a would-be cooperative organized by two corporations to produce primary aluminum, which the cooperative sold at cost to its patrons (*i.e.,* the two organizing corporations).[2]

The Service questioned whether the would-be cooperative was a cooperative in fact because of certain features (which need not concern us here), but conceded that if it were a cooperative, no transfer pricing adjustment would be appropriate. The IRS reasoned:

> [W]e believe the use of section 482 to allocate income would be inappropriate if [the entity] is determined to have been operated as a cooperative during those years. Section 482 was intended to ensure the use of arm's-length prices in dealings between related organizations. Implicit in the concept of an arm's length price is a profit element. A cooperative, however, is not designed to derive a profit from transactions with its patrons, but rather must operate at cost in its dealings with patrons. Consequently, *any attempt to impose the arm's-length pricing rules of section 482 upon a cooperative would interfere with the cooperative's adherence to one of the fundamental principles of cooperative operation*. [Italics added.]

This point was repeated in private letter rulings from 1994 and 1995. In the 1994 ruling, the IRS addresses a situation in which one entity ("A") acts as marketing agent for a sister company ("B"), an agricultural cooperative.[3] By agreement, all "profits" of A are assigned to B through an adjustment to cost of goods sold, with the result that A never shows a taxable profit. In 1991, according to the ruling, an IRS field agent "questioned whether such an arrangement was consistent with the 'arm's length standard'" under Code Sec. 482. The Office of Assistant Chief Counsel (Passthroughs and Special Industries) answered this question in an informal memorandum stating, without elaboration, that "if [A] is a cooperative within the meaning of subchapter T, then [a Code Sec. 482] reallocation would not be required." The 1994 ruling endorses this view, reaffirming that a cooperative may deal with its patrons by providing goods and services at cost, not constrained by the arm's length transfer pricing requirements of Code Sec. 482.

The facts of the 1995 ruling are identical in relevant respects to the 1994 ruling.[4] Like the earlier

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ruling, the 1995 ruling involves a corporation (A) that acts as the marketing agent for a related agricultural cooperative (B) and, as before, the ruling holds that if A operates on a cooperative basis, it may deal on non-arm's length terms with its patron/members, including B, without regard to Code Sec. 482. Although the conclusion reached by the 1995 ruling was not new, the 1995 ruling is notable because it acknowledges that transfer pricing concerns may be a legitimate reason to operate through a cooperative form. In its background statement of facts, the ruling notes that the decision to organize A as a cooperative was motivated, at least in part, by the desire to avoid transfer pricing liabilities. The ruling states that the persons organizing A as a cooperative did so because they "deemed it desirable to avoid, if possible, subjecting the intercompany pricing of sales [from B to A] to the vagaries of the complex and sometimes uncertain standards of 'arm's-length' analysis." Nothing in the ruling suggests that this motivation compromised the cooperative status of A or the transfer pricing immunity afforded by that status.

Foreign Patrons

Freedom from the transfer pricing constraints of Code Sec. 482 is desirable in any context, but its value is especially apparent in the case of foreign patrons that can obtain goods or services through a cooperative in the United States at cost without the need to defend against transfer pricing adjustments. It is good news for foreign persons, therefore, that a U.S. cooperative may have foreign as well as domestic patrons. Reported cases and IRS Revenue Rulings frequently reveal fact patterns involving cooperatives with foreign patrons. Indeed, a cooperative may operate in the United States with *only* foreign patrons, as was apparently the case in a 1979 private letter ruling involving a U.S. cooperative that was the wholly owned subsidiary of a Canadian corporation.[5]

> A cooperative is not restricted to dealing only with its members and, indeed, is not required to conduct all transactions on a nonprofit basis. To the contrary, the IRS has held that a cooperative may operate on a for-profit, nonpatronage basis with nonmembers. Indeed, a cooperative may do *most* of its business with nonmembers on a for-profit basis and still qualify as a cooperative.

Cooperative Defined

Code Sec. 1381(a)(2) defines a cooperative, in relevant part, as "any corporation operating on a cooperative basis."

Neither the Internal Revenue Code nor the regulations define the phrase "operating on a cooperative basis," but case law and IRS rulings identify certain key features, the three most important of which are:

(i) subordination of capital;
(ii) democratic control by patrons; and
(iii) the provision of goods or services by the cooperative to its patrons at cost.

The first of these, subordination of capital, requires that the cooperative exist for the benefit of its patrons rather than for the benefit of its equity owners (*i.e.*, the contributors of capital). As a practical matter, the distinction between patron and equity owner may not be very important because the identity of the patrons and the equity owners will likely be the same and the extent of ownership is likely to parallel the owner's expected level of patronage. Nevertheless, to the extent there is a divergence, equity owners take a back seat. All benefits of cooperative status flow to patrons as patrons; ownership status is ignored.

The second key feature of a cooperative, related to the first, is democratic control by the patrons.

> Democratic control is effected by having the [patrons] themselves periodically assemble in democratically conducted meetings at which each member has one vote and one vote only, and at which no proxy voting is permitted, and these [patrons] there deal personally with all problems affecting the conduct of the cooperative.[6]

According to the IRS, the third feature – operating at cost — is "perhaps the most fundamental." A cooperative does not attempt to make a profit on its sales to patrons (which, after all, would inure to the benefit of its equity owners in violation of the first principle stated above). Rather, the goal of a cooperative is to provide a needed service to member/patrons on a nonprofit basis, passing the cost savings to its members in proportion to each member's use of its services.

Flexibility of Cooperative Form

Other requirements for cooperative status must be carefully considered, but the cooperative form is not a straight-jacket. A cooperative is not restricted to dealing only with its members and, indeed, is not required to conduct all transactions on a nonprofit basis. To the contrary, the IRS has held that a cooperative may operate on a for-profit, nonpatronage basis with nonmembers. Indeed, a cooperative may do *most* of its business with nonmembers on a for-profit basis and still qualify as a cooperative.

In Revenue Ruling 93-21,[7] the IRS examined a situation in which a cooperative marketed a product for 10 members and 90 nonmembers, with nonmember business accounting for more than 75 percent of the cooperative's total business by value. The IRS held that this was not inconsistent with cooperative status, explaining that the Code "does not preclude a nonexempt cooperative from dealing with nonmembers on a for-profit basis," and further noting "[t]here is no requirement that in order for an organization to obtain the benefits of a non-exempt cooperative under subchapter T that both members and nonmembers be treated equally."

We recognize the tendency of tax lawyers to mistake tax issues for the entire dog and not just its tail. We do not believe, and do not suggest, that important matters of corporate organization (*e.g.*, whether to operate through a cooperative) will, or should, be controlled by transfer pricing considerations. Nevertheless, it strikes us that the cooperative form shares many similarities with joint ventures, and that some joint ventures might be recast as cooperatives with relatively little effort or disruption to the commercial objective of the joint venturers. In these cases, it makes eminent good sense to consider the transfer pricing freedom granted to cooperatives (but not necessarily to joint ventures) in considering issues of organization and corporate form.

Whether a cooperative makes more sense than a joint venture in a particular case is open to question, but it is a question that should be asked.

ENDNOTES

1 *See* Patricia G. Lewis and Matthew W. Frank, Transfer Pricing Thoughts: North America, *Thoughts on Joint Ventures*, J. GLOBAL TRANSFER PRICING, February–March 1999, at 9.

2 GCM 38595, Dec. 29, 1980.

3 LTR 9443009, July 18, 1994.

4 LTR 9547015, Aug. 24, 1995.

5 LTR 7918105, Jan. 31, 1979.

6 *Puget Sound Plywood*, 44 TC 305, 308, Dec. 27,419.

7 Rev. Rul. 93-21, 1993-1 CB 188.