



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
CHIEF COUNSEL

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

DATE: April 25, 2001

MEMORANDUM FOR JUNE Y. BASS
ASSOCIATE AREA COUNSEL (LMSB) CC:LM:CTM:LN
ATTN: Sandy Hwang, Attorney

FROM: Richard D. Fultz, Acting Deputy Associate Chief Counsel
(International - Litigation)

SUBJECT:

This Chief Counsel Advice responds to your memorandum dated January 25, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND:

Amount A	=
Amount B	=
Amount C	=
Amount D	=
Amount E	=
Amount F	=
Amount G	=
Amount H	=
Amount I	=
Amount J	=
Amount K	=
Amount L	=
Amount M	=

Amount N	=
Amount O	=
Amount P	=
Amount Q	=
Amount R	=
Amount S	=
Amount T	=
Amount U	=
Amount V	=
Amount W	=
Amount X	=
Amount Y	=
Amount Z	=
Amount AA	=
Amount BB	=
Amount CC	=
Amount DD	=
<u>Case 1</u>	=

Company A	=
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Company B	=
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Company C	=
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Country A	=
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Country B	=
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Country C	=
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Date 0	=
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Date 1	=
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Date 2	=
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Date 3	=
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Date 4	=
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Date 5	=
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Date 6	=
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Date 7	=
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Date 8	=
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Date 9	=
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Date 10	=
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Date 11	=
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Foreign Company 1	=
Foreign Company 2	=
Foreign Company 3	=
Individual A	=
Individual B	=
Number X	=
Number Y	=
Number Z	=
Rate A	=
Rate B	=
Rate C	=
Rate D	=
Rate E	=
State A	=
Sub 1	=
Taxable Year 1	=
Taxable Year 2	=
Taxable Year 3	=
Taxable Year 4	=
Taxable Year 5	=
Taxable Year 6	=
Taxable Year 7	=
Taxable Year 8	=
Taxable Year 9	=
Taxable Year 10	=

ISSUE:

Whether the proposed noncompliance penalty adjustment under section 6038A(e)(3) should be imposed to disallow interest expense deductions for Company A, Sub 1, and Company B for Taxable Years 4 through 6.

CONCLUSION:

Based upon the facts presented and for the reasons stated below, the Office of Associate Chief Counsel (International) concurs with the imposition of the proposed penalty under section 6038A(e)(3).

FACTS:

General Background

Company A, Company B, and Sub 1 (hereinafter collectively referred to as the “A Entities”) are United States corporations. Sub 1 is Company A’s wholly-owned subsidiary and is included in Company A’s consolidated Federal income tax return. The A Entities are currently under audit for Taxable Years 4 through 6, and the relevant statute of limitations for assessment of tax will expire on Date 0. The A Entities have indicated they do not intend to extend this statute of limitations.

In Taxable Years 4 through 6, Foreign Company 1, a Country A corporation, owned all outstanding shares of Company A’s voting preferred stock. Individual A, a United States citizen, owned all outstanding shares of Company A’s non-voting common stock. There were no other outstanding Company A shares. All outstanding shares of Company B were owned by Company C, a United States corporation. Company C was owned by Foreign Company 1. Foreign Company 1 was owned by Foreign Company 2, a Country B corporation.

At all relevant times, Individual A was president of the A Entities. The individuals holding the positions of vice president, secretary, and treasurer are believed to be common to all the A Entities. Individual B, Individual A’s son, was a Director of all of the A Entities.

In each of Taxable Years 4 through 6, Company A filed consolidated Federal income tax returns and reported over \$10 million in U.S. gross receipts. Company B filed its own corporate Federal income tax returns for Taxable Years 4 through 6 and reported over \$10 million in U.S. gross receipts in each taxable year.

Foreign Company 3 is a Country A corporation with its headquarters in Country C. Foreign Company 3 has a place of business in Country A at the same address as Foreign Company 1. The public records of Country A indicate that Foreign Company 3 was incorporated in Country A but is not authorized to do business there. No Country A public filing requirements apply to Foreign Company 3 and its corporate information, including ownership, is unavailable. For the taxable years at issue, the A Entities claim they are not related to Foreign Company 3 within the meaning of section 6038A. Foreign Company 3, however, owned all the outstanding preferred stock of Company B through the end of Taxable Year 3.

The A Entities and Foreign Company 3 have been involved in a number of transactions before, during, and after Taxable Years 4 through 6. Based on these transactions and other facts, it appears that Foreign Company 3 is a foreign related party with respect to the A Entities within the meaning of section 6038A. We set forth below our understanding and analysis of the relevant facts.

The “Safekeeping Agreement”

On Date 1, a date during Taxable Year 1, Company A entered into a “Safekeeping Agreement” with Foreign Company 1, its parent company. According to its terms, this agreement was intended to preserve Company A assets against “income shortfalls” and “pending or unforeseen litigation all of which may cause unjustified claims against the corporate assets.” Pursuant to the Safekeeping Agreement, on or about Date 2 (a date during Taxable Year 2), Company A purportedly transferred \$ Amount A to Foreign Company 1 at Rate A %. The Safekeeping Agreement did not provide for annual interest payments to Company A. Rather, Foreign Company 1 would “support [Company A’s] interest expense from third party sources” up to Rate A % annually of \$ Amount A. Company A reported \$ Amount B as a loan to Foreign Company 1 on a Form 5472 (Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business) attached to its Taxable Year 2 consolidated income tax return.

In Taxable Year 8, pursuant to a “Global Settlement” (discussed below), Foreign Company 1 purportedly transferred \$ Amount B to Foreign Company 3, on behalf of Company A, as repayment of the Safekeeping Agreement principal amount. Foreign Company 1 also purportedly transferred to Foreign Company 3, on behalf of Company A, \$ Amount C, *i.e.*, all of the Rate A % interest accrued over the term of the Safekeeping Agreement. Company A did not report any interest income from Foreign Company 1 on its consolidated income tax returns in Taxable Years 2 through 8.

The Line of Credit Transactions Involving Foreign Company 3

The Line of Credit to Company A (Taxable Year 1)

On Date 3, a date during Taxable Year 1, Foreign Company 3 purportedly provided Company A with a line of credit in the amount of \$ Amount D. The loan agreement provided for an interest rate of Rate B % and was collateralized by the assignment of Number X notes and deeds of trust with a face value of \$ Amount E (“the Notes”). The Notes included Number Y Company B notes (payable to Company A) with a face value of approximately \$ Amount F.

Company A reported the transfer of the Notes as a sale on its Taxable Year 1 consolidated income tax return and claimed a \$ Amount G loss (having determined the value of the Notes was \$ Amount H). Notwithstanding the purported transfer of the Notes to Foreign Company 3, their discounted face value of \$ Amount H was shown on Company A’s consolidated income tax returns for Taxable Year 2 and subsequent taxable years as notes receivable from a d.b.a. of Company A (*i.e.*, from itself). The assignment of the Notes was not recorded in the relevant Offices of the County Recorder and thus was not reflected in public records.

Because Foreign Company 3 did not maintain any offices in the United States, it designated Company A to be its “Collection Agent” for the interest on the Notes. As compensation for Company A’s services as Collection Agent, Foreign Company 3

agreed to a Rate C % payment deferral. If Company A, as agent, collected interest income from the transferred Notes in excess of Rate C %, the excess income would be used to decrease the principal due on the line of credit. Company A, however, never drew against this line of credit.

In Taxable Years 2 through 6, Company A collected interest on the Notes for Foreign Company 3 in the following amounts:

Taxable Year 2	\$ Amount I
Taxable Year 3	\$ Amount J
Taxable Year 4	\$ Amount K
Taxable Year 5	\$ Amount L
Taxable Year 6	\$ Amount M

Company A did not include these amounts in income for tax purposes. Company A informed the various payors that the Notes had been transferred to Foreign Company 3, but did not inform them that Foreign Company 3 was a foreign entity. Thus, none of the third party payors withheld tax on the interest paid.¹

The Line of Credit to Sub 1 (Taxable Year 3)

On Date 4, a date during Taxable Year 3, Foreign Company 3 extended to Sub 1 a line of credit in the amount of \$ Amount N. This line of credit was evidenced by a so-called “registered note” so that there would be no section 1442 withholding requirements. The first draw on this line of credit, in the amount of \$ Amount O, was made in Date 5, a date during Taxable Year 3.

The terms of the second line of credit parallel those of the first line of credit. The interest rate was Rate B %, with Rate C % deferred until payoff of the balance due. The collateral for the second line of credit was the same Number X notes used to collateralize the line of credit to Company A. Under the terms of the governing agreement, Sub 1 (through its parent, Company A) was to be Foreign Company 3’s “Collection Agent.”

In Taxable Year 3 and subsequent taxable years, Company A deducted Rate A % interest expense for the draws on Sub 1’s line of credit on its consolidated income tax returns.

¹ It is not clear whether Company B withheld tax on the payments made on its own notes.

The Line of Credit to Company B (Taxable Year 4)

On Date 6, a date during Taxable Year 4, Company B received a \$ Amount P line of credit from Foreign Company 3. The terms of this line of credit are similar to the terms for the lines of credit extended to Sub 1 and Company A. The interest rate on the line of credit to Company B is Rate D %. This line of credit had an opening balance of \$ Amount Q, which represented a consolidation of Company B's then-existing indebtedness for certain notes and construction loans. Foreign Company 3 charged Company B \$ Amount R for loan origination, travel, and other fees for the line of credit, which amount was added to the balance of the loan outstanding and deducted by Company B for income tax purposes.

A portion of the \$ Amount Q beginning balance on this line of credit was due to Company A's purported Taxable Year 4 sale of Company B's promissory notes, payable to Company A, to Foreign Company 3. On Date 6, Company A purportedly sold Number Z of the Number X notes. These Number Z notes were among the Number Y Company B notes payable to Company A that were collateralizing, in part, the lines of credit to Company A and Sub 1. Company A's sale of the Number Z Company B notes to Foreign Company 3 was not reported on Company A's Taxable Year 4 consolidated income tax return.

The parties treated the sale of the Number Z Company B notes as if Company B had borrowed funds from Foreign Company 3 under Company B's line of credit in order to repay Company A. As a result, Company B paid Foreign Company 3 a Rate D % rate of interest on the Number Z notes, whereas previously Company B had paid approximately Rate E % (i.e., a lower rate of interest) to Company A. While Company A purportedly sold the Number Z Company B notes in Taxable Year 4, Foreign Company 3 did not pay or otherwise compensate Company A for the Number Z notes until the payoff of all the lines of credit in Taxable Year 9.

On Date 6, Foreign Company 3 purportedly extinguished its ownership of all the outstanding preferred stock of Company B. It appears that Company B had given Foreign Company 3 the preferred stock as collateral for prior loans.

The Collection Arrangement for the Lines of Credit

As required under the line of credit agreements, Company A and Sub 1 collected interest income from the assigned Notes on behalf of Foreign Company 3 in a separate bank account, referred to in the agreements as the "Collection Account." Individual A and the other common officers of the A Entities opened a domestic bank account in the name of Foreign Company 3 and signed the bank signature card using their A Entities titles. Only officers of the A Entities had signature power over this account. In addition to collecting interest on the Notes, Individual A represented himself in Taxable Year 6 as Foreign Company 3's Director in litigation relating to collection issues.

Any expenses related to the collection of interest were drawn from the Collection Account. Any draws on the lines of credit were made from this same bank account. There is not, however, any underlying documentation as to funds actually transferred to or originating from Foreign Company 3. Rather, interest income was deposited into the account and roughly a similar amount was withdrawn as an advance on the lines of credit, resulting in a circular flow of funds.²

The collection arrangement appears to have given Individual A and the other officers of the A Entities complete control of the interest income from the assigned Notes, without having to report to Foreign Company 3 regarding the Collection Account activities.

The Global Settlement

In Taxable Year 8, the A Entities and Foreign Company 3 purportedly entered into a “Global Settlement,” pursuant to which the balances due on the lines of credit were to be paid. There is no written documentation for the Global Settlement, other than the agreements for the lines of credit themselves, which mention the maturity dates for the balances due. Under the terms of the Global Settlement, Foreign Company 1 purportedly repaid the \$ Amount A loan that it received from Company A in Taxable Year 2 (pursuant to the Safekeeping Agreement) by remitting \$ Amount B to Foreign Company 3 on Company A’s behalf. Since Company A had never drawn on its line of credit, the parties treated the \$ Amount B “repayment” as a reduction of the balance due on Sub 1’s line of credit. In addition to the principal amount of \$ Amount A, Foreign Company 1 also transferred to Foreign Company 3, on behalf of Sub 1, all of the Rate A % interest accrued on the \$ Amount A over the duration of the loan (a total of \$ Amount U).

Under the terms of the Global Settlement, Company A purportedly sold the Notes to Foreign Company 3. (As discussed above, Number Z of the Notes had been sold to Foreign Company 3 in Taxable Year 4.) In Taxable Year 9, Foreign Company 3 reduced the outstanding balance on Sub 1’s line of credit by \$ Amount V for the purchase of the Notes. But, at this time, the total unpaid balance on the Notes was \$ Amount W (an amount about 10% of \$ Amount V). The \$ Amount V balance reduction included the proceeds for the Taxable Year 4 sale of the Number Z notes. The remaining balance on Sub 1’s line of credit was purportedly paid in Taxable Years 9 and 10, although there is no supporting documentation for any additional repayments.

Foreign Company 3 as a “Related Party” of the A Entities

² For example, from Date 7 through Date 8 (dates during Taxable Year 4), Company B made a total of \$ Amount S in interest and principal payments on its promissory notes. Then, within three months’ time, on Date 9 and Date 10, Company B drew on its line of credit for a roughly equivalent amount, \$ Amount T.

The facts and circumstances of the numerous, complicated transactions between the A Entities, Foreign Company 1, and Foreign Company 3 support the conclusion that Foreign Company 3 is a section 6038A “related party.” We initially note that the lines of credit appear to be related party transactions, given that the A Entities and Foreign Company 3 saw no need to document or contemporaneously account for significant (*i.e.*, multi-million dollar) draws and repayments. In fact, the only records relating to the lines of credit appear to have been prepared by Company A’s accountant after the audit commenced. There is additionally no evidence that any funds deposited into Foreign Company 3’s U.S. bank account (the Collection Account) were ever transferred to or received by Foreign Company 3. We discuss below direct indicia of the common control of the A Entities and Foreign Company 3, as well as facts indicating a common plan or purpose to arbitrarily shift income and deductions, which triggers a presumption of control under Treas. Reg. § 1.482-1(i)(4).

Direct Indicia of Control by Individual A and Individual B

Individual A is the president of Company A, Sub 1, and Company B. Individual B, Individual A’s son, is a Director of Company A, Sub 1, and Company B. The A Entities claim they are not related to Foreign Company 3. In at least one of the taxable years at issue, however, Individual A has represented himself as a Director of Foreign Company 3. In Taxable Year 6, in the context of State A litigation relating to collection issues on the Notes, Individual A signed an “Association of Attorneys” as Director of Foreign Company 3. Given the dearth of reliable information on the ownership and/or control of Foreign Company 3, we believe this fact is significant, especially when considered in light of other available information.³ It appears that Individuals A and/or B controlled both the A Entities and Foreign Company 3 in taxable years including Taxable Year 6.

Facts Indicating a Common Plan or Purpose to Arbitrarily Shift Income and Deductions, Triggering a Presumption of Control

In addition to the direct indicia of control discussed in the preceding paragraph, the A Entities’ loan and line of credit transactions with Foreign Company 1 and Foreign Company 3 do not appear to have taken place at arm’s length and suggest a common plan to arbitrarily shift income and deductions, thereby triggering the presumption of control under Treas. Reg. § 1.482-1(i)(4). While certain other transactions between the A Entities and Foreign Company 3 appear to involve, to a greater or lesser extent, the arbitrary shifting of income and deductions, this discussion addresses solely the transactions closely connected to the claimed

³ For example, in Case 1, Individual B represented that he was Director of Foreign Company 3 and had made certain significant securities investment decisions on Foreign Company 3’s behalf in Taxable Years 8 and 9.

interest expense deductions, which are the object of the proposed noncompliance penalty adjustment under section 6038A(e)(3).

Pursuant to the Safekeeping Agreement, on Date 1 Company A agreed to loan \$ Amount A to Foreign Company 1 at Rate A %. Then, on Date 3 (a date approximately 2 months later), Company A opened a line of credit with Foreign Company 3 (at Rate B %, a significantly higher rate of interest). Though this line of credit was never used, Company A appears to have assigned several million dollars in interest income (a total of \$ Amount DD over Taxable Years 2 through 6) to Foreign Company 3 as consideration for the line of credit. For tax purposes, Company A treated the assignment of the Notes as a sale and claimed a \$ Amount G loss on its Taxable Year 1 consolidated income tax return. Thus, as a result of the concerted action of Company A and Foreign Company 3, the interest income on the Notes entirely escaped United States income taxation and Company A reduced its United States income tax liability by the amount of the claimed loss. (Moreover, Company A does not appear, at any time, to have reported its interest income from the Safekeeping Agreement on its income tax return.) The shifting of income appears even more arbitrary when it is considered that the A Entities maintained complete control over the Collection Account into which the interest income was deposited and were not required to report to Foreign Company 3 regarding the Collection Account activities. The flow of funds through the Collection Account appears to have been largely circular, with interest income deposited into the account and roughly a similar amount withdrawn as advances on the lines of credit.⁴

The line of credit to Sub 1 similarly appears to have been part of a common plan to reduce the United States tax liability of the Company A consolidated group through interest expense deductions. The Company A consolidated group apparently lacked available funds as a result of its earlier decisions to transfer \$ Amount A to Foreign Company 1 and assign the income stream from the Notes to Foreign Company 3. Given this factual background, the significant disparity between the interest rate charged by Foreign Company 3 and the interest rate charged by Company A itself (to Foreign Company 1 under the Safekeeping Agreement) — as well as the use of the already-assigned Notes as collateral — creates doubts concerning the arm's length character of the line of credit to Sub 1.

The line of credit to Company B presents further elements of a common plan to reduce the A Entities' overall United States tax liability. As part of this transaction, the parties treated a sale of Company B notes by Company A to Foreign Company 3 as if Company B had borrowed funds from Foreign Company 3 under this line of credit to repay Company A. As a result, the interest rate applicable to the amount represented by the notes increased from approximately Rate E % to Rate D %. As it appears that the Company B notes remained in existence, Company B arbitrarily

⁴ See supra note 2.

increased its corresponding interest expense deduction without any fundamental change in the obligation underlying the indebtedness.

Interest Expense Deductions in Taxable Years 4 through 6

Company A's consolidated income tax returns for Taxable Years 4 through 6 contain the following interest expense deductions relating to the line of credit transaction between Sub 1 and Foreign Company 3:

Taxable Year	Interest Expense Deduction from Company A and Subsidiaries Consolidated Return
Taxable Year 4	\$ Amount X
Taxable Year 5	\$ Amount Y
Taxable Year 6	\$ Amount Z

Company B's income tax returns for Taxable Years 4 through 6 contain the following interest expense deductions relating to line of credit transactions with Foreign Company 3:

Taxable Year	Interest Expense Deduction from Company B Return
Taxable Year 4	\$ Amount AA
Taxable Year 5	\$ Amount BB
Taxable Year 6	\$ Amount CC

Authorization of Agency Request

As discussed herein, Foreign Company 3 appears to be a foreign related party with respect to the A Entities within the meaning of section 6038A. On Date 11, the Service sent Company A, Sub 1, and Company B letters requesting an agency designation for a foreign related party under section 6038A(e). The Service needs to obtain information from Foreign Company 3 so that it may determine the correct tax treatment of the transactions between the A Entities and Foreign Company 3, including the deductibility of interest expenses claimed in Taxable Years 4 through 6. Foreign Company 3 has indicated it will not authorize the reporting corporations (the A Entities) to be its agent for section 6038A purposes and, to date, no authorization has been received by the Service. For the taxable years at issue, Foreign Company 3 claims that it never held stock in the A Entities directly or as a security interest, and that the A Entities never held stock in Foreign Company 3. The Service desires to apply the section 6038A(e)(3) penalty to disallow the interest expense deductions for Taxable Years 4 through 6 of the Company A consolidated group and of Company B. Pursuant to IRM 42.9.1.1(1)(b), Associate Area Counsel

has requested this Office to review and concur with the imposition of the proposed noncompliance penalty.

LAW AND ANALYSIS:

Section 6038A was enacted to aid the Service in the enforcement of section 482, in light of the difficulties the Service had experienced in obtaining information from foreign parents of United States corporations. The noncompliance penalty of section 6038A(e)(3) is among the principal enforcement mechanisms of the statute. See, e.g., ASAT, Inc. v. Commissioner, 108 T.C. 147, at 161-162 (1997).

Section 6038A requires a “reporting corporation” — i.e., a United States corporation that is 25-percent or more foreign-owned (directly or indirectly) — to timely report transactions between the reporting corporation and its 25% foreign shareholders (direct and indirect) and other related parties, as well as to maintain and make available records regarding such transactions. A foreign person is a 25-percent foreign shareholder of a corporation if the person owns at least 25 percent of all classes of the stock of the corporation by vote or value. I.R.C. § 6038A(c)(1); Treas. Reg. § 1.6038A-1(c)(3)(i). A foreign person is an indirect 25-percent foreign shareholder if it owns indirectly (or under the attribution rules of section 318 is considered to own indirectly) at least 25 percent of all classes of the stock of the reporting corporation, either by vote or value. Treas. Reg. § 1.6038A-1(c)(3)(iv). Section 6038A(c)(2) defines “related party” as any 25-percent foreign shareholder of the reporting corporation, any person who is related within the meaning of section 267(b) or 707(b)(1) to the reporting corporation or to a 25-percent shareholder of the reporting corporation, and any person who is related within the meaning of section 482 to the reporting corporation.

Reportable foreign related party transactions are listed in Treas. Reg. § 1.6038A-2(b)(3) and (4) and include, among other monetary transactions: amounts loaned and borrowed; interest paid and received; and amounts paid and received not specifically identified in Treas. Reg. § 1.6038A(b)(3) to the extent that such amounts are taken into account for the determination and computation of the taxable income of the reporting corporation.

Section 6038A(e)(3) provides that, with respect to any transaction, the amount of the deduction allowed under subtitle A (Income Tax) of the Internal Revenue Code for any amount paid or incurred by the reporting corporation to a related party in connection with such transaction shall be the amount determined by the Secretary in the Secretary’s sole discretion from the Secretary’s own knowledge or from such information as the Secretary may obtain through testimony or otherwise. As relevant here, section 6038A(e)(3) applies to any transaction between the reporting corporation and a related party who is a foreign person unless such related party agrees to authorize the reporting corporation to act as such related party’s limited agent solely for purposes of applying sections 7602, 7603, and 7604 with respect to any request by the Secretary to examine records or produce testimony related to any such transaction. I.R.C. § 6038A(e)(1).

A reporting corporation must provide requested authorizations of agency from foreign related parties so long as it does not fall within the small corporation exception under Treas. Reg. § 1.6038A-1(h) or the de minimis rule of Treas. Reg. § 1.6038A-1(i). Under the small corporation exception, a reporting corporation that has less than \$10,000,000 in U.S. gross receipts for a taxable year is not subject to the record maintenance requirements or the authorization of agent requirement for that taxable year. For purposes of the small corporation exception:

U.S. gross receipts includes all amounts received or accrued to the extent that such amounts are taken into account for the determination and computation of the gross income of the corporation. For purposes of this test, the U.S. gross receipts of all related reporting corporations shall be aggregated.

Treas. Reg. § 1.6038A-1(h). Treas. Reg. § 1.6038A-1(i) provides that a reporting corporation is not subject to the record maintenance requirements or the authorization of agent requirement for any taxable year in which the aggregate value of all gross payments it makes to and receives from foreign related parties with respect to related party transactions is not more than \$5,000,000 and is less than 10 percent of its U.S. gross income. The aggregate value of gross payments made to (or received from) a foreign related party with respect to foreign related party transactions cannot be netted; rather, it is determined by totaling the dollar amounts of the foreign related party transactions described in Treas. Reg. § 1.6038A-2(b)(3) and (4) required to be reported on all Forms 5472 filed by the reporting corporation or related reporting corporations. Treas. Reg. § 1.6038A-1(i)(2).

Analysis:

At all relevant times, Company A is a reporting corporation under section 6038A(a) because all of its voting stock is owned by Foreign Company 1, a Country A corporation. Sub 1 and Company B are reporting corporations because they are both owned indirectly by Foreign Company 1. The loan transactions at issue are of a type covered by Treas. Reg. § 1.6038A-2(b)(3).

The small corporation exception to the authorization of agent requirement is not applicable because Company A, Sub 1, and Company B had over \$10 million each in U.S. gross receipts in each of Taxable Years 4 through 6. The de minimis exception of Treas. Reg. § 1.6038A-1(i) does not apply to the Company A consolidated group nor to Company B for any of the taxable years at issue. Company A's loan to Foreign Company 1, pursuant to the Safekeeping Agreement, was in an amount greater than \$5 million and remained outstanding through Taxable Years 4 through 6. Sub 1 drew on its line of credit (from Foreign Company 3) in an amount greater than \$5 million in Taxable Year 3, and its balance on the line of credit remained greater than \$5 million through Taxable Years 4 through 6. Company B's Taxable Year 4 opening balance on its line of credit (from Foreign

Company 3) was greater than \$5 million, and its balance on the line of credit remained greater than \$5 million through Taxable Years 4 through 6.

Section 6038A(c)(2)(C) provides that “related party” includes “any . . . person who is related (within the meaning of section 482) to the reporting corporation.” Section 482 applies where two or more organizations, trades or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) are owned or controlled directly or indirectly by the same interests. The section 482 regulations refer to a “controlled taxpayer,” rather than “related party,” and, accordingly, we look to the definition of “controlled taxpayer” for guidance.⁵

A “controlled taxpayer” is “any one of two or more taxpayers owned or controlled directly or indirectly by the same interests, and includes the taxpayer that owns or controls the other taxpayers.” Treas. Reg. § 1.482-1(i)(5). The term “controlled”:

includes any type of control, whether legally enforceable or not, and however exercisable or exercised, including control resulting from the actions of two or more taxpayers acting in concert or with a common goal or purpose. It is the reality of the control that is decisive, not its form or the mode of its exercise. A presumption of control arises if income or deductions have been arbitrarily shifted.

Treas. Reg. § 1.482-1(i)(4). The requisite section 482 control is one of “actual, practical control rather than any particular percentage of stock ownership.” B. Forman & Co. v. Commissioner, 54 T.C. 912, 921 (1970), aff’d in part and rev’d in part, 453 F.2d 1144 (2d Cir. 1972). The question of control in this case involves a factually intensive inquiry and is complicated by the lack of documentation and the inconsistent (and sometimes conflicting) information the Service has obtained regarding transactions between the A Entities and Foreign Company 3. It is further complicated by the unwillingness of the A Entities, Individuals A and B, and Foreign Company 3 to provide any information identifying the owners of Foreign Company 3. For purposes of this request for concurrence, we, however, conclude there is sufficient information to find that the A Entities and Foreign Company 3 are commonly controlled and thus related parties within the meaning of section 6038A(c)(2).

The objective of the requested authorization of agency is to obtain additional information regarding certain interest expense deductions relating to transactions with Foreign Company 3 and claimed by the A Entities in Taxable Years 4 through 6. In light of the circumstances of these transactions and the refusal of the A Entities and Foreign Company 3 to provide information necessary to determine whether

⁵ Although the section 6038A standard is “related” and the section 482 standard is “controlled,” we do not believe this difference is significant in light of the legislative history indicating Congress intended section 6038A to apply to transactions within the scope of section 482. See H. Rept. 101-247, at 1295 (1989).

these transactions have economic substance, we conclude that the proposed adjustment is not unreasonable.

In sum, the A Entities have not provided the requested authorization of agent forms for Foreign Company 3, their related party. The Service (as delegated by the Secretary), therefore, may exercise its authority to determine the proper amount of allowable deductions based upon the information in its possession. After reviewing the facts in this case and the proposed adjustment, this Office concurs with the proposed application of the noncompliance penalty adjustment under section 6038A(e)(3).

Other Concerns

IRM Handbook 4.3.1.1(1) provides that a taxpayer will be sent informal and formal notices before the imposition of the section 6038A(e)(3) penalty. In general, formal notice should not be sent until 60 days after the mailing of the informal notice. In the present case, in light of the imminent expiration of the statute of limitations (on Date 0), and the A Entities' indication that they will not extend the statute of limitations, you have asked whether the 60-day waiting period between notices could be reduced to 30 days.

The IRM Handbook does not require a 60-day period between the informal notice and the formal notice, but rather refers to this period as one which should ideally be allowed. IRM Handbook 4.3.1.1(2) sets forth an express exception where, as here, a short period of time remains on the statute of limitations at the time the informal notice is issued. In accordance with these guidelines, we consider it appropriate in the present case to reduce the period between the informal notices and the formal notices to 30 days.

Please call (202) 874-1490 if you have any further questions.

By: RICHARD D. FULTZ
Acting Deputy Associate Chief Counsel
(International - Litigation)
Office of Chief Counsel