



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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Number: **200247045**
Release Date: 11/22/02

CC:INTL:6
PRENO-130801-02

UILC: 6038A.02-01

INTERNAL REVENUE SERVICE NATIONAL OFFICE LEGAL ADVICE

DATE: August 23, 2002

MEMORANDUM FOR: JEFFREY JOHNSON
INTERNATIONAL TECHNICAL ADVISOR LMSB:PFT:I

FROM: Elizabeth Beck
Chief CC:INTL:6

SUBJECT: Related Parties Under I.R.C. Section 6038A

This Technical Assistance responds to your memorandum dated June 3, 2002. This Technical Assistance does not relate to a specific case and is not binding on Examination or Appeals. This document is not to be used or cited as precedent.

ISSUES

1. Whether US Corp 1 and US Corp 2 are considered related parties per section 6038A and the regulations thereunder.
2. Whether the sales transactions between US Corp 1 and US Corp 2 must be reported 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).

CONCLUSIONS

1. Based on the information provided, US Corp1 and US Corp 2 are not related parties per section 6038A and the regulations thereunder.
2. Based upon the above conclusion, the sales transactions between US Corp1 and US Corp 2 are not reportable on a Form 5472.

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FACTSOverview

US Corp 1, a domestic corporation, is wholly owned by Individual A, a foreign individual. As such, US Corp 1 is a reporting corporation as defined by section 6038A. Individual A and _____, Individual B, serve as officers of US Corp 1. Individual C, a U.S. resident and the _____ of Individual B, wholly owns US Corp 2, a domestic corporation. ForCorp 1, a foreign manufacturing corporation, is owned by unrelated parties. ForCorp 2, a foreign _____ corporation, is owned _____ % by Individual A, _____ % by Individual B, _____ % by Individual C and _____ % by Individual D, also a _____ of Individual B. The remaining _____ % is owned by unrelated parties. ForCorp 3, a foreign _____ corporation, is owned _____ % by Individual A, _____ % by Individual B and _____ % by Individual C.

US Corp 1 imports goods and further distributes such goods to other domestic entities, principally US Corp 2. The majority of the goods are supplied to US Corp 1 by ForCorp 1 either directly, or indirectly through ForCorp 2 and ForCorp 3. US Corp 1 currently is the principal supplier of goods to US Corp 2. Prior to the formation of US Corp 1, US Corp 2 principally purchased goods directly from ForCorp 1, ForCorp 2 and ForCorp 3.

US Corp 1 files a Form 5472 with respect to the transactions it entered into with ForCorp 2 and ForCorp 3.

Relationship between US Corp 1 and US Corp 2

US Corp 1 _____ to US Corp 2. It is not known whether any _____ was actually paid by US Corp 2 to US Corp 1 nor whether such _____ were equal to what unrelated entities similarly situated would pay.

Under a credit facility, US Corp 1 executed _____ notes to a bank for \$ _____ and \$ _____, signed by Individual A and _____, Individual B, in their capacities as Chief Executive Officer and Chief Financial Officer, respectively, of US Corp 1. The interest rate on these loans was the _____. Individual A provided personal guarantees with respect to these loans. In addition, both US Corp 2 and Individual C guaranteed the bank loans to US Corp 1. It is not known how the signatures of the officers of US Corp 1 were able to bind US Corp 2 to the note.

US Corp 1 advanced US Corp 2 interest bearing subordinated loans in the amount of \$ _____

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Corp 1 and US Corp 2 have also entered into other various inter-company loans, for less than market rate of interest. No interest was paid by US Corp 2 to US Corp 1 with respect to the inter-company notes.

purportedly provided by US Corp 2 to US Corp 1. No information is provided regarding these or how US Corp 1 and US Corp 2 reported these transactions on their respective income tax returns.

US Corp 1 issued in its corporate name to Individual C. The incurred by the use of these were allocated to several ledger accounts as business expenses. The amount of the by Individual C totaled \$. No reimbursement was made by Individual C to US Corp 1 for the incurred. US Corp 1 also booked and expensed certain purchases made on behalf of US Corp 2. There is no evidence of repayment of such purchases.

LAW

Each section 6038A “reporting corporation” must make a separate annual information return on Form 5472 (Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business) with respect to each “related party” with which the reporting corporation has had any “reportable transaction” during the taxable year. Treas. Reg. § 1.6038A-2(a)(1).

Reportable transactions are listed in Treas. Reg. § 1.6038A-2(b)(3) and (4) and include, among other monetary transactions, sales and purchases of stock in trade (inventory) and sales and purchases of tangible property other than stock in trade, rents, interest, amounts borrowed or loaned and consideration received or paid for managerial services.

A reporting corporation is a domestic corporation that is 25% foreign-owned. Section 6038A(a). A corporation is 25% foreign-owned if at least 25% of (i) the total voting power of all classes of stock of the corporation entitled to vote or (ii) the total value of all classes of stock of the corporation, is owned, directly or indirectly, at any time during the taxable year by one foreign person (a “25% foreign shareholder”). Section 6038A(c)(1) and Treas Reg. § 1.6038A-1(c)(2). A foreign person is any person who is not a United States person, as defined by section 7701(a)(30). Section 6038A(c)(3). A domestic corporation is a United States person. Section 7701(a)(30). Indirect ownership refers to ownership through a corporation, partnership, trust or estate. See Rev. Proc. 91-55, 1991-2 C.B. 784, and Treas. Reg. § 1.6038A-1(m), ex. 4.

For purposes of measuring ownership, the attribution rules of section 318 apply, with certain modifications. Section 6038A(c)(5). Under section 318, an

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individual shall be considered as owning the stock owned, directly or indirectly, by or for his spouse, children, grandchildren and parents. Section 318(a)(1). Stock that is attributed from one family member to another under this rule cannot then be reattributed to another family member. Section 318(a)(5)(B). In addition, if 50% or more in value of the stock in a corporation is owned, directly or indirectly, by or for any person, such corporation shall be considered as owning the stock owned, directly or indirectly, by or for such person. Section 318(a)(3)(C).

Section 6038A(c)(2) defines a related party as (i) any 25% foreign shareholder of the reporting corporation, (ii) any person who is related (within the meaning of section 267(b) or section 707(b)(1)) to the reporting corporation or to a 25% foreign shareholder of the reporting corporation, and (iii) any other person who is related to the reporting corporation within the meaning of section 482. For purposes of measuring ownership, the attribution rules of section 318 apply. Section 6038(A)(c)(5) (see discussion in prior paragraph).

Under section 267(b), two corporations are related if they are members of the same "controlled group". A controlled group includes two or more corporations if, among certain other tests, five or fewer persons who are individuals own stock possessing (i) at least 50% of the total combined voting power of all classes of stock entitled to vote or at least 50% of the total value of shares of all classes of the stock of each corporation, and (ii) more than 50% of the total combined voting power of all classes of stock entitled to vote or more than 50% of the total value of shares of all classes of stock of each corporation, taking into account the stock ownership of each such person only to the extent such stock ownership is identical with respect to each such corporation. Sections 267(f)(1) and 1563(a). When determining ownership of stock for purposes of ascertaining whether there is a controlled group, an individual shall be considered as owning the stock owned, directly or indirectly, by his spouse (except under certain circumstances not relevant here) and minor children. Section 1563(e)(5) and (6). An individual who otherwise owns more than 50% of the total stock of a corporation, by vote or value, shall be considered as owning the stock in such corporation owned, directly or indirectly, by or for his parents, grandparents, grandchildren, and children who have attained the age of 21 years. Section 1563(e)(6)(B). Stock constructively owned by a person by reason of this rule shall not be treated as owned by him for the purposes of again applying this rule to make another person the constructive owner of such stock. Section 1563(f)(2)(B).

In addition, under section 267(b)(2), an individual and a corporation are related if more than 50% in value of the outstanding stock of the corporation is owned, directly or indirectly, by or for such individual. For purposes of determining the ownership of stock in applying section 267(b), an individual shall be considered as owning the stock owned, directly or indirectly, by or for his family. Sections 318(a)(1) and 267(c)(2). Under section 318(a)(1), the family of an individual

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includes his spouse, children, grandchildren and parents. Section 267(c)(4) further includes in an individual's family his siblings and all other ancestors and lineal descendants. Stock constructively owned by a person by reason of this rule shall not be treated as owned by him for the purposes of again applying this rule to make another person the constructive owner of such stock. Sections 318(a)(5)(B) and 267(c)(5).

Section 707(b)(1) describes certain relationships of partnerships with partners or with other partnerships.

Section 482 applies where two or more organizations, trades or businesses are owned or controlled directly or indirectly by the same interests. The section 482 regulations refer to a "controlled taxpayer," rather than "related party". 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 purposes. 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 regulations provide no guidance as to what the term "same interests" means under section 482. Case law indicates "it is not necessary that the same person or persons own or control each controlled business before section 482 can be applied, but there must be a common design for the shifting of income in order for different individuals to constitute the same interests. Brittingham v. Commissioner, 598 F.2d 1375, 1379 (5th Cir. 1979) (ownership stakes held by two brothers were sufficiently disparate to create conflicting self-interests in the dealings between the two corporations). Accord DHL Corp. v. Commissioner, T.C. Memo. 1998-461 (1998), aff'd in part, rev'd in part, and remanded, 285 F.3d 1210 (9th Cir. 2002) (when the interests controlling one entity and those controlling another have a common interest in shifting income from the former to the latter, entities may be considered commonly controlled). See also B. Forman Co., Inc. v. Commissioner, 453 F.2d 1144 (2d Cir. 1972), nonacq., 1975-2 C.B. 3 (two independently owned corporations acting in concert to make interest-free loans to a jointly owned corporation constituted the same interests within the meaning of section 482); South Texas Rice Warehouse Co. v. Commissioner, 366 F. 2d 890 (5th Cir. 1966) (four unrelated family units owning proportionate amounts of a corporation and partnership constituted same interests within the meaning of section 482 where the partnership was set up to reallocate income within the families).

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ANALYSIS

The first question is whether US Corp1 and US Corp 2 are related parties. US Corp 2 will qualify as a related party to US Corp1 for purposes of section 6038A if it is (i) a 25% foreign shareholder of US Corp1, (ii) related to US Corp1 or Individual A under section 267(b) or section 707(b)(1), or (iii) related to US Corp1 within the meaning of section 482. See section 6038A(c)(2).

Because US Corp 2 is a domestic corporation and therefore a United States person, it is not a foreign person. Sections 6038A(c)(3) and 7701(a)(30). US Corp 2 is not a 25% foreign shareholder of US Corp 1 and therefore is not a related party under the first test.

Looking at the second related party test, US Corp 2 will be related to US Corp1 under section 267(b) if both corporations are members of the same controlled group as defined in section 1563(a), that is, if Individual A and Individual C in the aggregate own more than 50% of the stock of each of US Corp 1 and US Corp 2, taking into account each individual's stock ownership in one corporation only to the extent such individual owns an equal amount of stock in the other corporation. In this case, Individual A owns 100% of the stock of US Corp 1, but does not directly own any stock of US Corp 2. Similarly Individual C owns 100% of the stock of US Corp 2, but does not directly own any stock of US Corp 1. Under section 1563, there is no attribution of ownership to _____, nor can stock attributed to a family member be reattributed to another individual. Therefore, though US Corp1 stock held by Individual A can be attributed to _____, Individual B, it cannot be reattributed to _____, Individual C. The US Corp 2 stock held by Individual C cannot be attributed to _____, Individual B, let alone reattributed from Individual B to _____ Individual A. Therefore neither Individual A nor Individual C own stock of both US Corp 2 and US Corp1 for purposes of this test and hence the two corporations are not members of the same controlled group.

US Corp 2 will be related to Individual A under section 267(b) only if Individual A owns, directly or indirectly, more than 50% in value of the outstanding stock of US Corp 2. Individual A does not own directly any stock of US Corp 2. Though there is _____ attribution under section 267(b), stock attributed to a family member cannot be reattributed to another individual. The US Corp 2 stock held by Individual C can be attributed to _____, Individual B, but the stock cannot be reattributed from Individual B to _____, Individual A. Therefore Individual A does not directly or constructively own more than 50% of US Corp 2 and hence is not related to US Corp 2 under section 267(b).

Section 707(b)(1) is not applicable in determining the related party status of US Corp 2 as none of US Corp 1, US Corp2 or Individual A is a partnership.

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Because US Corp 2 is not related to US Corp1 or Individual A under either section 267(b) or section 707(b)(1), US Corp 2 is not a related party under the second test.

The final related party test is the section 482 ownership/common control test. US Corp 1 and US Corp 2 will be related parties for purposes of section 6038A if, under section 482, they are owned or controlled directly or indirectly by the “same interests.” US Corp 1 is wholly owned and therefore controlled by Individual A. US Corp 2 is wholly owned and therefore controlled by Individual C. Individual A and Individual C may be treated as the “same interests” for purposes of this test if they are acting pursuant to a common design to shift income or deductions.

In B. Forman, *supra*, two unrelated corporate shareholders each held a 50% interest in a newly-formed company to which they made loans without interest. By not reporting interest on these loans, the shareholders had less taxable income and the company, by not paying interest, eliminated a deduction that would have increased the yearly losses it was reporting. The Second Circuit Court of Appeals concluded that the shareholders, though unrelated, were acting in concert in making the interest free loans to the company and found that the company was in fact controlled by the “same interests” for purposes of section 482. B. Forman, 453 F.2d at 1154-5.

In South Texas Rice Warehouse, *supra*, four unrelated families each owned a 25% interest in a corporation. The same families formed a partnership, again, each family unit owning a 25% interest. Though the families as a unit owned the same percentage interest in each of the corporation and the partnership, the ownership varied among the individuals within each family such that individuals owning 100% of the partnership only owned 65% of the corporation. The two individuals holding 35% of the corporation that did not participate in the partnership were fathers of two of the family units. The partnership leased the operating assets of the corporation, but the payments under the lease were less than arm’s length and therefore not sufficient to cover the corporation’s expenses, thus generating losses in the corporation and increasing income of the partnership. The Fifth Circuit Court of Appeals held that the corporation and the partnership were controlled by the same interests, though owned by various individuals, because each family unit maintained a 25% stake in both the corporation and the partnership and because the partnership was formed for the purposes of reallocating among certain family members. South Texas Rice Warehouse, 366 F. 2d at 894-96.

By contrast, in Brittingham, *supra*, the Fifth Circuit Court of Appeals later held that although two corporations were controlled by the same family unit, the members of the family unit did not necessarily constitute the same interests. In this case, Juan and his wife, Roberta, owned essentially 100% of a corporation, Ceramica, that manufactured tile and 37% of a second corporation, Dallas Ceramic,

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which, along with manufacturing tile itself, purchased tile from Ceramica for resale. Dallas Ceramic was also held 37% by Juan's brother, Robert, with the remaining 26% held by various relatives. Both parties agreed that the family unit consisting of Roberta, Juan and Robert collectively controlled both corporations, but disagreed on whether they constituted the "same interests" for purposes of section 482. The Commissioner cited a number of transactions that he claimed reflected a common design to artificially divert more than \$1.5 million of income from Ceramica to Dallas Ceramic, based on what the Commissioner claimed were artificially low sales prices, and which therefore evidenced control by the same interests. The court noted that the families of Robert and Juan were financially independent and that Robert would have no incentive to be a part of a plan to shift \$1.5 million from a company in which he and his wife owned a 100% stake to a company in which he only owned a 37% stake. The court held there was not sufficient evidence to show a common design to arbitrarily shift income and that therefore the two corporations were not controlled by the same interests. Brittingham, 598 F. 2d 1375, at 1378-1379.

In the case at hand, the facts have not been sufficiently developed to reach a conclusion that Individual A and Individual C are acting in concert to arbitrarily shift income and therefore constitute the same interests for purposes of section 482. It is not known whether US Corp 2 is in fact paying _____ on the _____ it _____ from US Corp 1 nor whether the _____ is an "arm's length" rate. Similarly, it is not clear whether any valid _____ are being provided by US Corp 2 to US Corp 1

.¹ There does not appear to be any direct connection between the bank loans to US Corp 1 and the inter-entity loans from US Corp 1 to US Corp 2, as they do not have matching maturity dates and the bank loans are a _____ rate versus the _____ rate on the inter-entity loans. The timing of the loans is also unclear. There is no evidence whether guarantee fees were paid by US Corp 1 to US Corp 2 in return for US Corp 2's guarantee of U.S. Corp 1's bank loans. Further information on the amounts and purposes of the expenses incurred by US Corp 1 on behalf of US Corp 2 as well as information on the sales transaction prices for sales between US Corp 1 and US Corp 2 would also assist in determining whether there is evidence of arbitrary shifting of income.

¹ It is unknown how US Corp 1 and US Corp 2 reported the income and expenses on their respective returns.

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Because there is insufficient factual evidence to determine whether US Corp 1 and US Corp 2 are commonly controlled under section 482, we cannot conclude that US Corp 2 is a related party to US Corp 1 under section 482 and the third related party test of section 6038A.

Your second question is whether the reporting requirements of section 6038A apply to US Corp 2's transactions with US Corp 1. If US Corp 2 is not a related party to US Corp 1, then there are no reporting requirements as to any transactions between US Corp 1 and US Corp 2.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS



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