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INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE LEGAL ADVICE

DATE: August 20, 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 ForCorp are considered related parties per section 6038A and the regulations thereunder.
2. Whether the sales transactions between US Corp 1 and ForCorp 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 Corp 1 and ForCorp are not related parties per section 6038A and the regulations thereunder.
2. Based upon the above conclusion, the sales transactions between US Corp 1 and ForCorp are not reportable on a Form 5472.

FACTS

US Corp 1, a domestic corporation, is owned 55% by Individual A and 45% by Individual B (the husband of Individual A's wife's sister), both foreign individuals. As such, US Corp 1 is a reporting corporation as defined by section 6038A. US Corp 2, a domestic corporation, is wholly owned by Individual C, a U.S. resident

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and the brother of the wife of Individual A. ForCorp, a foreign manufacturing corporation, is 20% owned by Individual C and 80% owned by six other unrelated individuals.

US Corp 1 imports goods and further distributes such goods to other domestic entities, principally US Corp 2. The majority of the goods is supplied to US Corp 1 by ForCorp. These goods comprise a substantial majority of the goods manufactured by ForCorp. Prior to the formation of US Corp 1, ForCorp sold these goods directly to US Corp 2.

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.

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). 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 constructive ownership rules of section 318 apply, with certain modifications. Section 6038A(c)(5) and Treas. Reg. § 1.6038A-1(e)(1). Under section 318, an 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

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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 6038A(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)(2). 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 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 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 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

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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. It is the reality of the control that is decisive, not its form or the mode of its exercise. Treas Reg. § 1.482-1(i)(4).

The proposition that actual control, rather than legal or beneficial control, can constitute control for section 482 purposes is supported by the case law and by examples in the regulations under section 6038A. Charles Town Inc. v. Commissioner, 372 F.2d 415 (4th Cir. 1967) (holding that two shareholders were in control of a corporation in which they owned two percent of the outstanding stock because of their possession of effective and practical control over the corporation); Ach v. Commissioner, 42 T.C. 114 (1964), aff'd, 358 F.2d 342 (6th Cir. 1966) (mother deemed in control of corporation of which she was president, treasurer and chairman of the board of directors and for which she managed the day-to-day operations even though stock of the corporation was nominally held by her sons); Grenada Indus. Inc. v. Commissioner, 17 T.C. 231 (1951), aff'd, 202 F. 2d 873 (5th Cir. 1953), acq. in part and nonacq. in part, 1952-2 C.B. 2. In examples 5 and 6 of Treas. Reg. § 1.6038A-1(m), a 25% shareholder of a corporation is determined to control such corporation under section 482 where the other 75% of the stock is widely held, but not where the other 75% of the stock is held by only one other unrelated shareholder.

When control does not exist through majority ownership of voting stock or a legally enforceable agreement delegating the power to direct an entity’s actions, the section 482 regulations provide alternatively that control may result from the action of two or more taxpayers acting in concert or with a common goal or purpose. In addition, a presumption of control arises under the regulations if income and deductions have been arbitrarily shifted. Treas. Reg. § 1.482-1(i)(4).

Once control is found to exist, it must be established that the two or more corporations are controlled by the same interests. 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.

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1972), nonacq., 1975-2 C.B. 3 (two independently owned corporation 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).

ANALYSIS

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

For purposes of determining whether ForCorp is a 25% foreign shareholder of US Corp 1, any US Corp 1 stock held by a 50% shareholder of ForCorp will constructively be considered held by ForCorp. ForCorp owns no stock directly or indirectly, through another entity, in US Corp 1 and has no 50% shareholders through which it could constructively own any stock in US Corp 1. Because it owns no stock of US Corp 1 directly, indirectly or constructively, ForCorp is not a 25% foreign shareholder of US Corp 1 and therefore is not a related party under the first test.

ForCorp will be related to US Corp 1 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, Individual B and Individual C in the aggregate own more than 50% of the stock of each of US Corp 1 and ForCorp, 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 55% of US Corp 1, but does not directly own any stock of ForCorp. Similarly, Individual B owns 45% of US Corp 1, but does not own directly any stock of ForCorp. Individual C, who owns 20% of ForCorp, is the brother-in-law of both Individual A and Individual B. Under section 1563, there is no attribution of ownership to siblings, nor can stock attributed to a family member be reattributed to another individual. Therefore US Corp 1 stock held by Individual A can be attributed to his wife, but cannot be reattributed to her brother, Individual C. The ForCorp stock held by Individual C cannot be attributed to Individual C's sister, Individual A's wife, let alone reattributed from Individual A's wife to Individual A. By similar analysis, there can be no attribution of stock in either direction between Individual B and Individual C, who are also brothers-in-law. Because neither Individual A nor Individual B nor Individual C own stock of both US Corp1 and ForCorp, none of the stock they own in either corporation is counted for purposes of the greater than 50% test. Therefore the two corporations are not members of the same controlled group.

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ForCorp will be related to Individual A or Individual B under section 267(b) only if Individual A or Individual B owns, directly or indirectly, more than 50% in value of the outstanding stock of ForCorp. Neither Individual A nor Individual B owns directly or indirectly, through a corporation, partnership, trust or estate, any stock of ForCorp. Though there is sibling attribution under section 267(b), stock attributed to a family member cannot be reattributed to another individual. The ForCorp stock held by Individual C can be attributed to his sister, the wife of Individual A, but the stock cannot be reattributed from Individual A's wife to Individual A. Similarly, the ForCorp stock held by Individual C can be attributed to the wife of Individual B, also Individual C's sister, but cannot be reattributed from Individual B's wife to Individual B. Even if reattribution were permitted, Individual C only owns 20% of the stock of ForCorp, less than the requirement of over 50%. Neither Individual A nor Individual B directly or constructively owns more than 50% of ForCorp and are therefore not related to ForCorp under section 267(b).

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

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

The final related party test is the section 482 ownership/control test. US Corp 1 and ForCorp 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. Indirect ownership, though not defined in the section 482 context, is presumed to mean ownership through a corporation, partnership, trust or estate. In this case, neither ForCorp nor US Corp 1 is owned directly or indirectly by the same interests.

As to control, the majority shareholder, Individual A, arguably controls US Corp 1. However, Individual C, the only shareholder of ForCorp that is related to Individual A, owns only 20% of the stock of ForCorp. This is neither a majority interest nor, because the rest of the stock of ForCorp is closely held by a small group of unrelated persons, does it appear to be a controlling interest. As discussed above, there may be other ways of demonstrating that Individual C has actual control of ForCorp. A presumption of control may arise where income and deductions have been shifted arbitrarily. Such shifting of income may also be evidence that US Corp 1 and ForCorp are controlled by the same interests for section 482 purposes.

In the case at hand, we have no factual evidence pointing to actual control of ForCorp by Individual C nor do we have any evidence showing an arbitrary shifting of income between US Corp 1 and ForCorp that would give rise to a presumption of

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control by the same interests under section 482. Absent such evidence, we cannot conclude that ForCorp is a related party to US Corp 1.

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

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

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