OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR ASSOCIATE DISTRICT COUNSEL
SOUTHERN CALIFORNIA DISTRICT, SAN DIEGO
ATTN: Robert E. Cudlip CC:WR:SCA:SD

FROM: Elizabeth G. Beck
Senior Technical Reviewer CC:INTL:BR6

SUBJECT:

This Field Service Advice responds to your memorandum dated October 27, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be used or cited as precedent.

LEGEND:

Activity A =

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	=
Business Activity 1	=
Country A	=
Country B	=
Date 1	=
Date 2	=
Date 3	=
Date 4	=
ForParent	=
ForSub	=
Product A	=
USSub1	=
USSub2	=
USSub3	=
USSub4	=
Taxable Year 1	=
Taxable Year 2	=
X	=

ISSUE:

Whether USSub1 is liable for an I.R.C. § 6038A(d) monetary penalty for its failure to report on the Form 5472 attached to its Taxable Year 2 Federal income tax return a guarantee fee payment made in Taxable Year 1, which payment served as the basis for an amortization deduction claimed by USSub1 on its Taxable Year 2 return.

CONCLUSION:

Yes. USSub1 is liable for an I.R.C. § 6038A(d) monetary penalty for its failure to report the guarantee fee payment on the Form 5472 attached to its Taxable Year 2 Federal income tax return, given that (1) the guarantee fee was taken into account in the determination and computation of USSub1's Taxable Year 2 taxable income

and (2) the failure to report made the Form 5472 for Taxable Year 2 "substantially incomplete."

FACTS:

USSub1, a domestic corporation wholly owned by ForParent, a Country A corporation, is a "reporting corporation" as defined in I.R.C. §§ 6038A(a) and (b) and therefore subject to section 6038A information reporting requirements.

USSub1 timely filed consolidated Federal income tax returns (Forms 1120) for itself and its subsidiaries for Taxable Year 1 and Taxable Year 2. USSub1's Taxable Year 1 return was not examined and the period of limitations for Taxable Year 1 has expired. USSub1's Taxable Year 2 return is currently under examination, and the period of limitations for assessment has been extended by a restricted consent to Date 4. USSub1's Taxable Year 2 income tax return reported gross receipts of $ Amount A and a net taxable loss of $ Amount B. USSub1 uses the accrual method of accounting.

USSub3 and USSub4 are wholly owned subsidiaries of USSub1 which were included in USSub1's consolidated Federal income tax returns for Taxable Year 1 and Taxable Year 2. On or about Date 1, ForParent entered into an agreement with USSub1 pursuant to which it undertook to guarantee the obligation of USSub3 and USSub4 to make an aggregate capital contribution of $ Amount D to a limited partnership (formed to carry out Activity A) on or before Date 3. On Date 2, a date 18 months before Date 3, USSub1 made a payment of $ Amount C to ForParent as consideration for the guarantee. On Date 3, USSub1's two subsidiaries contributed $ Amount D to the limited partnership, borrowing the funds from USSub2, a domestic corporation owned by ForParent.

USSub1 claims that the $ Amount C guarantee fee payment is amortizable for tax purposes over the 18-month period from the payment of the guarantee fee (Date 2) to the capital contribution by USSub3 and USSub4 (Date 3) in the amount of $ Amount E in each of Taxable Year 1 and Taxable Year 2. For financial accounting purposes, USSub1 chose to amortize the $ Amount C fee over the life of the Activity A project (X years).

Taxable Year 1

USSub1 did not claim an $ Amount E amortization deduction on its Taxable Year 1 income tax return, nor did it report on the attached Form 5472 (Information Return of a 25% Foreign-Owned Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business) relative to ForParent the $ Amount C payment or the unclaimed $ Amount E amortization deduction. The only transaction with ForParent reported on its Taxable Year 1 Form 5472 was $ Amount F as "Consideration paid for technical, managerial, engineering, construction, scientific, or like services."

USSub1 also reported the following amounts on another Form 5472 filed for Taxable Year 1 and relative to ForSub, a Country B corporation related to ForParent:

- $ Amount G paid to ForSub as "Consideration paid for technical, managerial, engineering, construction, scientific or like services";
- $ Amount H loaned to ForSub;
- $ Amount I interest paid to ForSub.

The Taxable Year 1 return provided by USSub1 to Examination is missing the second page of the Form 5472 relative to USSub2.

USSub1's balance sheet attached to its Taxable Year 1 return treated the $ Amount C payment as an asset categorized as "Investment in partnerships" (with $ Amount J recorded under each of USSub3 and USSub4). USSub1 did not file Form 1042 (Annual Withholding Tax Return for U.S. Source Income of Foreign Persons) for Taxable Year 1, taking the return position that the $ Amount C guarantee fee was insurance and, as such, exempt from taxation under the applicable tax treaty.

Taxable Year 2

USSub1 claimed two deductions on the Form 4562 ("Depreciation and Amortization") filed with its Taxable Year 2 return totaling $ Amount K (an $ Amount L deduction for amortization of costs that began before Taxable Year 2, and an $ Amount M deduction for amortization of costs that began during Taxable Year 2). USSub1 did not show the $ Amount C payment or the $ Amount K amortization deduction on its Taxable Year 2 Form 5472 relative to ForParent. USSub1 did, however, report the following amounts on the Forms 5472 filed for Taxable Year 2:

- $ Amount N paid to ForSub as "Consideration paid for technical, managerial, engineering, construction, scientific or like services";
- $ Amount O borrowed from ForParent;
- $ Amount P interest paid to ForParent.

Though USSub1 indicated it filed three Forms 5472 in Taxable Year 2 (see Taxable Year 2 Form 1120, Schedule K, Item 10(c); Form 5472, Part I, Item 1(f)), only two Forms 5472 were in fact filed (relative to ForParent and ForSub). Examination did not follow up on the missing third Form 5472 for Taxable Year 2.

USSub1 has also asked that the Taxable Year 2 Net Operating Loss Carryforward be amended to include the $ Amount E deduction not taken in Taxable Year 1.

LAW AND ANALYSIS:

A. **The I.R.C. § 6038A Reporting Requirements**

I.R.C. § 6038A was enacted amid concerns that foreign-owned U.S. companies were understating income, and thus minimizing tax liability, through the manipulation of transactions with their non-U.S. parent companies. See, e.g., Staff of Joint Comm. on Taxation, 99th Cong., General Explanation of the Tax Reform Act of 1986 (JCS-10-87) at 1053-1054 (J.Comm. Print May 4, 1987). Collecting the correct amount of tax from these companies was often frustrated where important financial records were kept at the parent company, in foreign languages, and in less detail than required in the United States. In order to permit the Internal Revenue Service to obtain the information necessary to effectively enforce U.S. tax laws as they apply to these companies and transactions, section 6038A introduced reporting and record-keeping requirements for certain foreign-owned domestic companies ("reporting corporations") involved in transactions with related parties.

Each section 6038A reporting corporation, such as USSub1, must make a separate annual information return on Form 5472 with respect to each "related party" with which the reporting corporation has had any "reportable transaction" during the taxable year, even where the information required may not affect the amount of any tax due under the Code. Treas. Reg. § 1.6038A-2(a)(1). In the present case, ForParent is a "related party" of USSub1 for the purposes of section 6038A, as ForParent is a 25-percent foreign shareholder of USSub1. ForSub is also a related party of USSub1 in that ForParent is a 25-percent shareholder of ForSub (in other words, ForSub is "related" to ForParent), and the definition of "related party" includes any person who is related to a 25-percent shareholder of the reporting corporation. I.R.C. § 6038A(c)(2); Treas. Reg. § 1.6038A-1(d).

Section 6038A(b) describes the information which the Secretary may require by regulations to be reported to include "transactions between the reporting corporation and each foreign person which is a related party to the reporting corporation." "Reportable transactions" are separated by Treas. Reg. § 1.6038A-2 into two types: foreign related party transactions for which only monetary consideration is paid or received by the reporting corporation (see Treas. Reg. § 1.6038A-2(b)(3)) and foreign related party transactions involving non-monetary consideration or less than full consideration (see Treas. Reg. § 1.6038A-2(b)(4)). With respect to those transactions involving solely monetary consideration, Treas. Reg. § 1.6038A-2(b)(3) states:

> If the related party is a foreign person, the reporting corporation must set forth on Form 5472 the dollar amounts of all reportable transactions for which monetary consideration (including U.S. and foreign currency) was the sole consideration paid or received during the taxable year of the reporting corporation. The total amount of such transactions, as well as the separate amounts for each type of transaction described below, must be reported on Form 5472, in the

> manner the form prescribes.... The types of transactions described in this paragraph are:
>
> (i) Sales and purchases of stock in trade (inventory);
>
> (ii) Sales and purchases of tangible property other than stock in trade;
>
> (iii) Rents and royalties paid and received (other than amounts reported under paragraph (b)(3)(iv) of this section);
>
> (iv) Sales, purchases, and amounts paid and received as consideration for the use of all intangible property ...;
>
> (v) Consideration paid and received for technical, managerial, engineering, construction, scientific, or other services;
>
> (vi) Commissions paid and received;
>
> (vii) Amounts loaned and borrowed (except open accounts resulting from sales and purchases reported under other items listed in this paragraph (b)(3) that arise and are collected in full in the ordinary course of business);
>
> (viii) Interest paid and received;
>
> (ix) Premiums paid and received for insurance and reinsurance; and
>
> (x) Other amounts paid or received not specifically identified in this paragraph (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.

(Emphasis added.)

For purposes of Treas. Reg. § 1.6038A-2, the terms “paid” and “received” shall include accrued payments and receipts, respectively, for accrual basis taxpayers. Treas. Reg. § 1.6038A-2(b)(8).

Part IV of Form 5472 requires the reporting corporation to provide detailed information on monetary transactions between the reporting corporation and foreign related parties, with a separate listing by type of transaction as indicated in Treas. Reg. § 1.6038A-2(b)(3) of amounts paid and received by the reporting corporation.

The Form 5472 required under section 6038A and Treas. Reg. § 1.6038A-2 shall be filed with the reporting corporation’s income tax return for the taxable year by the due date (including extensions) of that return, with a duplicate (including attachments and schedules) filed at the same time with the Philadelphia Service Center. Treas. Reg. § 1.6038A-2(d). Where a reporting corporation fails to furnish the required information within this deadline, I.R.C. § 6038A(d)(1) provides for a monetary penalty of $10,000 for each taxable year with respect to which such failure occurs.

Filing a "substantially incomplete" Form 5472 will constitute a failure to file Form 5472. Treas. Reg. § 1.6038A-4(a)(1).

B. **Discussion**

Treas. Reg. § 1.6038A-2(b)(3) makes it clear that reportable foreign related party transactions include enumerated transactions and any and all transactions which are taken into account in determining the reporting corporation's taxable income for the relevant year. The specific transactions listed in Treas. Reg. §§ 1.6038A-2(b)(3)(i)-(ix) are by definition reportable. Treas. Reg. § 1.6038A-2(b)(3)(x) functions as a catch-all provision, including among reportable transactions all other amounts paid or received which are not specifically identified in (i) through (ix) but which are in any case "taken into account for the determination and computation of the taxable income of the reporting corporation."

In the present case, USSub1 claimed two amortization deductions on its Taxable Year 2 return in connection with the guarantee fee payment.[1] The guarantee fee payment was thus taken into account by USSub1 in the determination and computation of its Taxable Year 2 taxable income, and fell within the "catch all" category (x) under Treas. Reg. § 1.6038A-2(b)(3). Consequently, it should have been reported on the Form 5472 attached to USSub1's Taxable Year 2 return.

Because USSub1 did, in fact, timely file a Form 5472 relating to ForParent with the required information on other reportable related party transactions for Taxable Year 2, it must be determined whether the failure to report the guarantee fee made its Taxable Year 2 Form 5472 "substantially incomplete" — and thus equivalent to a failure to file Form 5472. Although the regulations do not provide a definition of "substantially incomplete," they do provide that where information is not required to be reported, a Form 5472 filed without such information is not "substantially incomplete." Treas. Reg. § 1.6038A-4(a)(1). In interpreting the "substantially incomplete" standard, the policy behind section 6038A of providing a complete and accurate picture of a foreign-owned company's reportable related party transactions and, ultimately, the collection of the correct amount of U.S. Federal income tax from the reporting company should be paramount.

One could view the language of Treas. Reg. § 1.6038A-2(b)(3), which states that the amounts of the listed transactions "must be reported on Form 5472," as

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[1] For purposes of this advice, it is assumed that the amount at issue is in substance a guarantee fee. It was so reflected on transaction documents and so reported on taxpayer's Taxable Year 2 return. Taxpayers are limited in their ability to disavow the form of their transactions. See National Alfalfa Dehydrating & Milling Co., 417 U.S. 134 (1974); Estate of Durkin v. Commissioner, 99 T.C. 561 (1992); Coleman v. Commissioner, 87 T.C. 178 (1986).

compelling a finding that, where these items are not reported, the Form 5472 is "substantially incomplete" under Treas. Reg. § 1.6038A-4(a)(1). Under this view, since the guarantee fee payment was clearly taken into account in the determination of USSub1's Taxable Year 2 taxable income, as evidenced by USSub1's deductions for amortization in Taxable Year 2, the guarantee fee payment was thus required to be reported pursuant to Treas. Reg. § 1.6038A-2(b)(3)(x). USSub1's failure to report, in itself, made its Taxable Year 2 Form 5472 "substantially incomplete."

Another view is that the determination of whether the failure to report a particular reportable transaction makes a taxpayer's Form 5472 "substantially incomplete" requires the examination of all pertinent facts and circumstances. These facts and circumstances should include, among other things:

(1) the magnitude of the unreported transaction(s) in relation to reported transactions and whether the reporting corporation has other reported transactions with the same related party;
(2) the magnitude of the unreported transaction(s) in relation to the reporting corporation's volume of business and overall financial situation;
(3) the significance of the unreported transaction(s) to the reporting corporation's business in a broad (functional) sense;
(4) whether the unreported transaction(s) occur(s) in the context of a significant, ongoing transactional relationship with the related party; and
(5) whether the unreported transaction(s) is (are) reflected in the determination and computation of the reporting corporation's taxable income in the relevant year.

In this case, the following observations may be made concerning the factors enumerated above :

(1) The portion of the guarantee fee accrued (for purposes of determining USSub1's Taxable Year 2 taxable income) but not reported on Form 5472 for Taxable Year 2 ($ Amount K) is millions of dollars and five times larger than the total of the other amounts which were in fact reported on the Forms 5472 for Taxable Year 2 ($ Amount N, $ Amount O, and $ Amount P). USSub1 did in fact report two monetary transactions with ForParent on Form 5472 for Taxable Year 2: $ Amount O as "Amounts borrowed" and $ Amount P as "Interest paid."
(2) The unreported amount is equivalent to approximately ⅓ of USSub1's Taxable Year 2 gross receipts ($ Amount A) and approximately ½ of USSub1's Taxable Year 2 net taxable loss ($ Amount B). It is therefore significant in relation to USSub1's volume of business and overall financial situation.
(3) On its Federal income tax returns for Taxable Year 1 and Taxable Year 2, USSub1 indicates that its business activity is Business Activity 1 in Product A

(see Form 1120, Schedule K, Items 2(b) and (c)). The guarantee fee payment here is intended to guarantee the obligation to make a capital contribution to a limited partnership involved in Activity A, and is therefore directly connected with the stated object of USSub1's business activity.

(4) There appears to be at least a two-year relationship concerning this significant financial and legal transaction between USSub1, ForParent and other related parties.

(5) The guarantee fee payment was clearly taken into account in the determination of USSub1's Taxable Year 2 taxable income, as evidenced by USSub1's deductions for amortization for Taxable Year 2, and thus required to be reported pursuant to Treas. Reg. § 1.6038A-2(b)(3).

All these factors, considered together, make it clear that the guarantee fee payment was significant in light of the pertinent facts and circumstances and that the Form 5472 filed with the Taxable Year 2 return was "substantially incomplete."

Under either of the views discussed above, we believe USSub1 would be treated as having failed to file Form 5472 for Taxable Year 2 and be subject to a section 6038A(d) monetary penalty for this failure.

You should note that certain failures to report may be excused for reasonable cause. Treas. Reg. § 1.6038A-4(b)(1). Whether a taxpayer acted with reasonable cause and good faith will be determined on a case-by-case basis, taking into account all pertinent facts and circumstances (which include, among other things, the taxpayer's experience and knowledge). Treas. Reg. § 1.6038A-4(b)(2)(iii). If the penalty is imposed, USSub1 should be informed of its right to file a statement claiming reasonable cause pursuant to Treas. Reg. § 1.6038A-4(b)(2).

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

We based our advice on the assumption that the guarantee fee payment was in fact a reportable transaction under section 6038A for Taxable Year 2. Difficulties arise where, as here, an argument can be made that the transaction was not reportable for Taxable Year 2 and thus, if there is no requirement to report the payment, there would be no "deemed" failure to file, eliminating the section 6038A(d) monetary penalty. However, since Examination has not taken a position as to the character or deductibility (reportability) of the payment, we maintain that if USSub1 has taken a return position in which the guarantee fee was reflected in the computation of its Taxable Year 2 taxable income, it should also be reported on the Form 5472 filed with that year's return. Thus, taxpayer is bound by its return position for purposes of the section 6038A(d) monetary penalty, is not allowed to benefit from hindsight manipulation, and encouraged to perform up-front compliance, which is the underlying purpose of section 6038A(d) penalty.

We understand that a request for Field Service Advice concerning the character of the alleged guarantee fee payment is currently pending with CC:INTL. Should Examination ultimately determine that the payment is not deductible or is not included among the listed transactions under Treas. Reg. § 1.6038A-2(b), then the issue of whether to impose the section 6038A(d) monetary penalty should be resubmitted to this office for further consideration.
If you have any further questions, please call (202) 874-1490.

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