LB&I AUDIT INSIGHTS: USING A CODE §6038A SUMMONS WHEN A U.S. CORPORATION IS 25% FOREIGN OWNED

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INTRODUCTION

On January 30, the I.R.S. Large Business and International ("LB&I") Division published an international practice unit ("I.P.U.") outlining the steps its auditors should take when issuing a recordkeeping and reporting summons to a U.S. corporation that is 25% owned by a foreign shareholder.[1] More importantly, the I.P.U. advises I.R.S. examiners on steps to be taken when the response to the summons is viewed to be incomplete.

BACKGROUND

Under Code §6038A and subject to certain exceptions, a domestic "reporting corporation" that is 25% or more foreign-owned (a "D.R.C.") must provide the I.R.S. with information on certain transactions with the 25% foreign owner and any other foreign party that is related to the 25% foreign owner. The information is provided 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*.

Pursuant to regulations promulgated under this provision,[2] a D.R.C. must maintain records that may be relevant to determine the correct U.S. tax treatment of transactions with foreign related parties. Determining the correctness of the D.R.C.'s Federal income tax return may require the I.R.S. to examine data that is in the custody or control of a foreign related person. Generally, a summons issued by the U.S. government to a foreign person is not legally enforceable when that person resides in a foreign country.

For that reason and to ensure enforcement of record requests, Code §6038A(e) provides that the D.R.C. may be designated by a foreign related person as its agent to receive I.R.S. requests and summonses for records.[3]

The I.P.U. acknowledges that exceptions are provided for small corporations and transactions of *de minimis* value. A D.R.C. with less than $10 million of U.S. gross receipts in a tax year is not required to be authorized as an agent for that tax year. In addition, a D.R.C. with gross payments to and from foreign related parties of not more than $5 million and less than 10% of its U.S. gross income for a tax year is not required to be authorized as an agent for that year.

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1 See "Practice Units."

2 Subject to the small corporation exception of Treas. Reg. §1.6038A-1(h) and the safe harbor for reporting corporations with related-party transactions of *de minimis* value of Treas. Reg. §1.6038A-1(i).

3 Once a foreign related party designates a D.R.C. as a limited agent, that authorization is effective for all tax years not barred by the statute of limitations.

When the foreign related party does not designate the D.R.C. as agent, or when the D.R.C. fails to substantially comply[4] in a timely manner with an I.R.S. summons to produce records or take testimony, a noncompliance rule may be triggered.[5] The rule penalizes the D.R.C. by increasing its tax in a dramatic fashion. Deductions related to the transaction under examination may be disallowed. In addition, the price of property that is purchased by the D.R.C. from a foreign related party may be removed from cost of goods sold. The same enforcement rule applies when the D.R.C. purchases inventory for sale to a foreign related party. By ignoring purchases, the entire sales price will constitute gross income.

"If the U.S. disregarded entity does not generate effectively connected income for its sole foreign member, the enforcement tools to incentivize compliance may not be effective."

The I.P.U. advises examiners that the I.R.S. has sole discretion to determine the amount of the adjustment. In so doing, the I.R.S. may base its adjustments on its own knowledge and belief, and on information it chooses to obtain through testimony or otherwise. The I.R.S. may disregard any information or materials submitted by the D.R.C. or a foreign related person if the I.R.S. deems such information or materials insufficiently probative of the relevant facts. The adjustment, known as the noncompliance penalty, can be overridden only by clear and convincing evidence that the I.R.S. abused its discretion.

ISSUING A SUMMONS

Before issuing a summons, the examiner is encouraged to consider whether a treaty procedure can be used efficiently to obtain information. If records are obtainable within 180 days of an information exchange request pursuant to a tax treaty or tax information exchange agreement ("T.I.E.A."), the I.R.S. will generally turn to this resource first. The absence or pendency of a treaty or T.I.E.A. request is not grounds for a D.R.C. to refuse to comply with a summons and is not a defense against the noncompliance penalty.

Issuing a summons is permitted when the following criteria are met:

- The taxpayer under exam is a D.R.C.
- A transaction occurred between the D.R.C. and its 25% foreign shareholder or any foreign person related to the D.R.C. or to such 25% foreign shareholder.
- The D.R.C. is appointed to act as a limited agent with respect to any request by the I.R.S. to examine records or produce testimony that may be relevant to the tax treatment of any transaction between the D.R.C. and a foreign related party.

Pursuant to recently issued final regulations, a U.S. disregarded entity wholly owned by a foreign person is treated as a domestic corporation for the limited purpose of the reporting, record maintenance, and associated compliance requirements. Thus, such entities are included in the definition of a D.R.C. for purposes of issuing a summons.[6] If the U.S. disregarded entity does not generate effectively connected

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4 This is a facts and circumstances matter. The importance of the foreign-based documentation provided, not the number of documents or the proportion of the answered sections, govern.

5 Note that the I.R.S. must first notify the D.R.C., by certified or registered mail, that it has not substantially complied with the summons.

6 The exceptions from record keeping and designation as agent of the foreign

income for its sole foreign member, the enforcement tools to incentivize compliance may not be effective. Gross income may be zero before deductions and cost of goods sold are disallowed. However, the noncompliance penalty is only one type of enforcement tools available for the I.R.S. A monetary penalty applicable to the failure to timely file a complete and accurate Form 5472 and the failure to maintain and produce records may be imposed.

If a foreign related party is not a party to a properly executed agent authorization that appoints the D.R.C. to act as a limited agent, the I.R.S. may not issue a summons. Further, the I.R.S. may not issue a summons if the D.R.C. is excused from being designated as an agent pursuant to the small corporation exception or a *de minimis* safe harbor rule.

ENFORCEABILITY OF A SUMMONS

Generally, a court will enforce a summons if the following criteria are met:

- There is a legitimate purpose for the investigation.
- The material sought is relevant to that purpose.
- The material sought is not already within the I.R.S.'s possession.
- The administrative steps required by the Code have been taken.

Regarding the relevance of the material sought, the I.R.S. has the authority to examine any information that may be relevant to ascertain the correctness of a return, make a return when none was made, or determine the proper tax liability. Under a widely-accepted standard of relevance, information is relevant if it might have thrown light upon the correctness of the return.[7] However, there should be a realistic expectation that this information will lead to a discovery. An idle hope is not sufficient for a summons to be enforced.[8]

Relevant records include books, papers, electronic records, and other data of D.R.C. and any foreign related party that may be relevant or material to determine the correct U.S. tax treatment of a transaction.

JUDICIAL PROCEEDINGS

The I.P.U. recognizes that a D.R.C. may begin judicial proceedings in a U.S. district court to quash a summons. The motion must be filed within 90 days from the date on which the summons was issued.[9] In general, a motion to quash a summons is one of the more frequently litigated taxpayer issues and one on which the I.R.S. has an excellent record of success. The Taxpayer Advocate Service, which tracks most litigated issues and submits an annual report to Congress, recorded that in

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related party, which apply to U.S. corporations meeting the small corporation exception or the *de minimis* safe harbor rule, are not available to disregarded entities.

7 *Foster v. U.S.*, 265 F.2d 183 {2nd Cir. 1959).

8 *U.S. v. Harrington*, 388 F.2d 520 (2nd Cir. 1968).

9 *ASAT Inc. v. U.S.*, 76 AFTR2d 957821 (N.D. Cal.1995).

the 12-month period ending on June 30, 2014, 102 cases were brought by taxpayers or the I.R.S. to enforce or quash a summons. The I.R.S. prevailed in full in 97 cases, a 95% success rate. In the comparable period ending in 2015, 84 cases were brought, and the I.R.S. prevailed in full in 81 cases. It should be noted that more than two-thirds of the cases were brought by persons not represented by legal counsel.

The D.R.C. may also begin a judicial proceeding in U.S. district court to review an I.R.S. determination that the D.R.C. did not substantially comply with a summons. The proceedings must begin within 90 days from the day the notice of noncompliance was mailed. If not so appealed, the I.R.S. determination is binding and cannot be reviewed by any court.

CONCLUSION

On January 31, LB&I announced initial compliance campaigns, which included the Related-Party Transaction Campaign. The examination approach identified for that campaign reflects LB&I's transition towards issue-based examinations.

During the course of an examination, the I.R.S. will likely make a request for information regarding the control of a foreign related party when examining a D.R.C. It may even wish to examine the books and records of the foreign party that is related to the D.R.C. Although, the I.P.U. was not identified as an examination approach of this campaign, the issues are directly related and it is expected that a summons issued under Code §6038A will be a tool used by the international examiner in a contentious fact pattern.